

Annual Report 2009



Delivering Total Performance

THURSDAY



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22/04/2010
COMPANIES HOUSE

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CONTENTS

1. Overview

Results in brief, highlights and outlook
Chairman's letter
Chief Executive's review

2. Strategy

1	Strategic review	10
2	Market review	16
4	Global initiatives	20
	Strategy in action	22

3. Group performance

Key Performance Indicators (KPIs)
Financial review
Corporate Responsibility review
Risk management
Principal risks

26	Operating group performance summary	54
30	Electronics, Intelligence & Support	56
38	Land & Armaments	60
46	Programmes & Support	64
48	International	68
	HQ & Other Businesses	72

4. Segmental performance

5. Governance

Board of directors
Corporate governance
Remuneration report
Other statutory and regulatory information,
including statement of directors' responsibilities

76	Independent auditors' report	119
78	Consolidated financial statements	120
90	Notes to the Group accounts	124
	Company balance sheet	171
112	Notes to the Company accounts	172
	Five-year summary	180
	Shareholder information	182
	Financial calendar	183
	Glossary	184

6. Financial statements

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

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INFORMATION FOR SHAREHOLDERS ONLINE AT
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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 section 90A of the Financial Services and Markets Act 2000. It should be noted that section 90A 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.

BAE SYSTEMS AT A GLANCE

BAE Systems, with 106,900 employees¹ worldwide, delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and customer support services.

Group

- Sales¹ increased by 21%
- Underlying EBITA⁴ increased by 17%
- £261m accounting gain on US pension restructuring and £278m of regulatory penalties excluded from underlying EBITA⁴
- £973m of impairment charges largely relating to the ex-Armor Holdings business
- Underlying earnings³ per share up 10% to 40 7p
- Dividend for the year increased by 10% to 16 0p per share
- £500m market purchase of shares to commence

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

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

NUMBER OF EMPLOYEES^{1,3} BY OPERATING GROUP (%)

Electronics, Intelligence & Support

Principal operations

The Electronics, Intelligence & Support operating group designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications

Electronic Solutions
Information Solutions
Platform Solutions
Support Solutions

Main operating locations

p54 FOR MORE INFORMATION

HQ & Other Businesses

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

- 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 the Financial review on page 30)

Sales^{1,2,3}

£5,637m

Number of employees^{1,3}

32,000

Key points

- Maintained leadership position in electronic warfare systems
- Introduced new infrared technology solutions to improve the effectiveness of US Army troops
- Secured seven-year managed IT services contract for the US Treasury
- Expanded leadership position in hybrid electric propulsion for urban mass transit buses
- Selected to provide US military counter-insurgency support services under a five-year urgent-needs contract

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For more information

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Land & Armaments

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

Programmes & Support

Programmes & Support primarily comprises the Group's UK-based air, naval and security activities

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

International

International comprises the Group's businesses in Saudi Arabia and Australia, together with a 37.5% interest in the pan-European MBDA joint venture, and shareholdings in Saab of Sweden and Air Astana

CS&S International
BAE Systems Australia
MBDA (37.5% interest)
Saab (20.5% shareholding)
Air Astana (49% shareholding)

£6,738m

19,800

- Organisation realigned with global strategy
- High volume of vehicle reset and support activity
- Improving performance through rationalisation and efficiencies
- Loss of follow-on production contract for Family of Medium Tactical Vehicles

£6,298m

33,200

- Typhoon Tranche 3A secured
- Over £3bn of support orders received
- Astute submarine commenced sea trials
- Second Type 45 accepted off contract
- Acquisition of VT Group plc's 45% interest in the BVT joint venture, now 100% owned and re-named BAE Systems Surface Ships
- Detica security business performing strongly in the first full year since acquisition
- Continued rationalisation activity

£4,253m

19,700

- Entry into service of Typhoon aircraft under the Salam programme
- Order intake secured for three-year support to Typhoon aircraft for the Kingdom of Saudi Arabia
- Order award for Australian Air Warfare Destroyer build programme
- Delivery of four inshore patrol vessels to New Zealand MoD

RESULTS IN BRIEF, HIGHLIGHTS AND OUTLOOK

Our 2009 performance

RESULTS IN BRIEF

	2009	2008
Sales ¹ (KPI)	£22,415m	£18,543m
Underlying EBITA ² (KPI)	£2,220m	£1,897m
Operating profit	£982m	£1,718m
Underlying earnings ³ per share (KPI)	40.7p	37.1p
Basic (loss)/earnings per share ⁴	(1.9)p	49.6p
Order book ⁵	£46.9bn	£46.5bn
Dividend per share	16.0p	14.5p
Cash inflow from operating activities	£2,232m	£2,009m
Net cash as defined by the Group ⁶	£403m	£39m

SALES¹

£22.4bn +21% (KPI)
2008: £18.5bn

UNDERLYING EARNINGS³ PER SHARE

40.7p +10% (KPI)
2008: 37.1p

HIGHLIGHTS

- Sales¹ increased by 21%
- Underlying EBITA² increased by 17%
- £261m accounting gain on US pension restructuring and £278m of regulatory penalties excluded from underlying EBITA²
- £973m of impairment charges largely relating to the ex-Armor Holdings business
- Underlying earnings³ per share up 10% to 40.7p
- Dividend for the year increased by 10% to 16.0p per share
- £500m market purchase of shares to commence

OUTLOOK

In 2010, we anticipate growth for three of our four operating groups, whilst at Land & Armaments return on sales will improve as rationalisation and efficiency programmes progress. In aggregate, and despite a planned lower level of land vehicle activity, the Group continues to expect growth for 2010 based on constant exchange rate assumptions.

(KPI) References Key Performance Indicators (KPIs) (see pages 26 to 29) throughout the Report.

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 the Financial review on page 30)

3 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)

4 Basic (loss)/earnings per share in accordance with International Accounting Standard 33

5 Including share of equity accounted investments, order books and after the elimination of intra-group orders of £1.7bn (2008 £1.4bn)

6 See the Financial review on page 34 and note 27 to the Group accounts

CHAIRMAN'S LETTER

“BAE Systems continues to build successfully on its position as one of the world's largest defence companies.”

- Strong operating performance
- Broadly-based portfolio of businesses
- Clearly defined strategy
- Embedding Group-wide ethical business culture
- Global settlement of regulatory investigations

Dick Oliver Chairman

DIVIDEND PER SHARE (PENCE)

16.0p
2008 14 5p

BAE Systems continues to build successfully on its position as one of the world's largest, and most geographically diverse, defence companies. The Group comprises a broadly-based portfolio of businesses focused, through a clearly defined strategy¹, on the provision of defence, security and aerospace capabilities in its global home markets. This strategy is delivering good results from the Group's operations.

Although constrained by weakened economies, defence and security are expected to remain a priority focus for governments across our home markets. We will continue to seek growth in value for shareholders, but we are not complacent as to the challenges of the near term. Recognising the economic difficulties facing many of our customers, BAE Systems will continue to work closely with its customers to address their increasingly complex and often urgent requirements in the most cost-effective and affordable way.

On 5 February 2010, the Company announced a global settlement with the UK Serious Fraud Office and the US Department of Justice, which concluded the lengthy investigations commenced by those two authorities in 2004 and 2007, respectively.

Pursuant to the agreement with the Department of Justice, the Company agreed to plead guilty to one charge of conspiring to make false statements to the US government relating to certain regulatory filings and undertakings. The Company agreed to pay a fine of \$400m (£248m) and make additional commitments to the Department of Justice concerning its ongoing compliance. Under the agreement with the Serious Fraud Office, the Company agreed to plead guilty to one charge of breach of duty to keep accounting records in relation to payments made to a former marketing adviser in connection with the sale of a radar system by the Company to Tanzania in 1999. The Company agreed in relation to this matter to pay an agreed penalty of £30m comprising a fine to be determined by the Court with the balance paid as a charitable payment for the benefit of Tanzania.

The Company very much regrets and accepts full responsibility for these past shortcomings. These settlements enable the Company to deal finally with significant legacy issues. In recent years, the Company has systematically enhanced its compliance policies and processes with a view to ensuring that the Company is as widely recognised for responsible conduct as it is for high quality products and advanced technologies.

We continue to work to establish the highest standards of governance in BAE Systems, and in this report, we describe the processes and assurance that underpin our approach (see pages 78 to 84). I am pleased to report that work to embed the highest standards of responsible business conduct across the Group has progressed well, including an accelerated implementation of the Woolf Committee recommendations.

The composition of the Board² and its committees continues to evolve.

In August, the Group announced that Sir Nigel Rudd, a non-executive director, would retire from the BAE Systems plc Board with effect from 31 December 2009. Carl Symon, a non-executive director, has been appointed chairman of the Board's remuneration committee in place of Sir Nigel. Phil Carroll, also a non-executive director, will retire at this year's Annual General Meeting. I would like to thank Nigel and Phil for the valuable contribution they have both made to the Board. To ensure that we maintain the necessary range of skills, knowledge and experience on the Board, two new non-executive directors, Paul Anderson and Nick Rose, have recently joined the Board.

The Group announced the resignation of Walt Havenstein in June. Walt was a director of BAE Systems plc, and Chief Operating Officer, President and Chief Executive Officer of BAE Systems, Inc. Linda Hudson was appointed as Walt's successor in October.

Following consultation with members of the Board, the nominations committee proposed that my office as a non-executive director and chairman of the Board be extended until May 2013 subject to shareholder approval.

The performance of the business reflects the valuable work performed by our highly dedicated workforce in support of our customers and, in particular, those who work to maintain the security of ourselves and others at home and around the globe. It was particularly gratifying to see the efforts of two of our 106,900 people recognised through formal citations, including George Thompson, Business Development Director, BAE Systems Surface Ships, who was made an Officer of the Order of the British Empire (OBE) for services to the shipbuilding industry, and Glen Chappelle, a recently retired project manager with Global Combat Systems in Glascoed, who was made a Member of the Order of the British Empire (MBE) for services to the defence industry and to industrial heritage.

Complementing this external recognition, we have for some years operated a highly successful scheme for employees within BAE Systems, the Chairman's Award for Innovation. The scheme now generates over two thousand entries annually, encouraging and recognising innovation across the Group.

BAE Systems is a conservatively managed business with a large order book and long-term visibility across a large part of its broad business base. The Board has recommended a final dividend of 9.6p making a total of 16.0p for the year, an increase of 10% over 2008. At this level, the annual dividend is covered 2.5 times by underlying earnings (2008 2.6 times). Subject to shareholder approval at the 2010 Annual General Meeting, the dividend will be paid on 1 June 2010 to holders of ordinary shares registered on 23 April 2010.

Dick Oliver Chairman

CHIEF EXECUTIVE'S REVIEW

“BAE Systems has evolved to become one of the world’s leading defence companies and is well positioned to weather the pressures in its global markets.”

- Continued good demand for high-technology capabilities
- Further significant multi-year support contracts awarded
- Delivering growth from combat aircraft programmes
- Transitioning from peak activity in land systems

Ian King Chief Executive

The good operating performance of BAE Systems in 2009 reflects the good progress the Group has made in recent years, developing the business within a well-defined and consistently implemented strategic framework¹. That strategy underpins the Group's aim to deliver sustainable growth in shareholder value through a commitment to Total Performance for all its customers.

BAE Systems is a resilient business, well positioned to weather the pressures that result from the recent turbulence in global economies. The Group operates primarily in its seven home markets, and has a wide portfolio of products and capabilities serving defence customers across the air, land and sea domains. Many of the Group's programmes are subject to long-term contracts, and some include agreements designed to address and safeguard national capabilities.

Alongside its established defence-related activities, BAE Systems has a growing position in national security with a focus on information-based intelligence capabilities. The acquisition of Detica in September 2008 was a further step in the implementation of the Group's security strategy. BAE Systems is well placed to address opportunities in security markets, such as increasing focus on cyber threats.

The Group's geographic spread of business extends the diversity of its customer base. The strategy, to identify long-term sustainable markets around the globe and address those markets by building local industrial positions, is working to good effect. India has been identified as the Group's seventh home market and, in November, an agreement was signed with Mahindra & Mahindra to establish a joint venture in land systems.

Rapid changes in the nature and evolution of threats around the world have resulted in corresponding changes in priorities for many of the Group's customers. BAE Systems recognises that agility in addressing customers' requirements is becoming a key competitive discriminator.

Defence budgets in both the UK and the US are expected to come under further pressure, and with expectations of a more challenging business environment ahead, the focus on driving performance and efficiency in the business will be key. Cost reduction measures are being aggressively implemented across the Group.

US business

In the US, overall defence spending remains robust but the investment accounts, from which the Group derives significant business, are expected to be stressed by the continued cost of high tempo operations and rising manpower costs.

In April 2009, the US Secretary of Defense announced a re-prioritisation of programmes that is expected to continue to shape US defence procurement. Many of BAE Systems' activities are well aligned to those announced priority changes. In February 2010, the US Quadrennial Defense Review was published along with the US defence budget for the Fiscal Year 2011 (FY11). The FY11 base budget identifies an increase of 3.4% and within this base budget the investment account allocations were at the upper end of the Group's planning assumptions.

The Group's high technology capabilities in the US are expected to continue to be in demand. The business has a strong record of innovation, rapidly generating advanced, but cost effective, solutions to address complex problems.

RESPONSIBLE TRADING PRINCIPLES

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

In June, BAE Systems completed the acquisition of Advanced Ceramics Research, Inc. for \$14m (£9m). The acquisition supports BAE Systems' global Unmanned Aircraft Systems (UAS) strategy, adding small UAS platforms and ground segment capability to complement the Group's existing UAS capabilities.

A setback for the Group was the notification by the US Department of Defense in August 2009 and, following a re-evaluation of the bids, in February 2010 that a follow-on production contract for vehicles under the Family of Medium Tactical Vehicles (FMTV) programme had been lost.

UK and rest of world business

The outlook for UK defence spending remains difficult, but the Group has a large order book reflecting the firmly contracted long-term programmes that are a feature of BAE Systems' UK based business.

The largest of those programmes, the Typhoon combat aircraft, is set for further growth with increasing deliveries to both the four European partner nations and to the Kingdom of Saudi Arabia.

BAE Systems is a leader in the provision of multi-year, capability-based, support solutions. Approximately 40% of BAE Systems' sales in 2009 are Readiness & Sustainment related activity. In addition to established relationships in the UK, the Kingdom of Saudi Arabia and Australia, BAE Systems seeks to migrate its Readiness & Sustainment capabilities to other markets.

New multi-year UK support contracts were awarded in the year totalling over £2bn. Such contracts included support and maintenance of Harrier and Typhoon aircraft in service with the Royal Air Force, the Type 45 anti-air warfare destroyer (the Group's first major UK ship support contract), and Spearfish and Sting Ray torpedoes in service with the Royal Air Force and Royal Navy, respectively.

The governments of the Kingdom of Saudi Arabia and the United Kingdom also agreed detailed arrangements to provide support for Typhoon operations for a three-year period. These arrangements will be operated through a full availability service contract with BAE Systems. Eight Typhoon aircraft were delivered in the year to the Saudi customer under the 2007 Salam production contract.

In July, contracts were agreed by the four European partner nations for 88 Tranche 3A Typhoon aircraft with a contract value to the Group of approximately £2bn. The contracts extend visibility of Typhoon production for the next five years.

BAE Systems is also a significant participant on the US F-35 (Joint Strike Fighter) programme with the combination of both airframe assembly manufacture in the UK and electronic systems supplied from the Group's US operations. The F-35 is expected to progress to high volume production over the coming years.

In October, BAE Systems completed the acquisition of VT Group's 45% shareholding in BVT, creating a wholly-owned subsidiary, BAE Systems Surface Ships Limited. The acquisition followed an agreement with the UK Ministry of Defence in July defining a Terms of Business Agreement setting out a 15-year partnering arrangement, including lead roles for the business on defined surface shipbuilding and support programmes. A significant element of the workload underpinned by this agreement is the manufacture of the Royal Navy's new class of two 65,000 tonne aircraft carriers. Following award of manufacturing contracts, steel cutting commenced in July, marking the start of build of the first of class. The Royal Navy also saw Astute, the first of a new class of nuclear powered attack submarines, commence sea trials in November.

BAE Systems identifies unmanned systems as an increasing priority amongst its customers, driven by rapidly evolving requirements often to meet urgent operational needs. BAE Systems is developing a range of unmanned system solutions to meet those requirements.

In the UK, the Group is developing three unmanned air platforms. A small high endurance air system, Herti, has been operationally deployed. A large twin-engined air platform, Mantis, commenced flight trials in October just 19 months after conception. A third development platform, Taranis, a stealthy unmanned combat air system, is in-build.

People and Total Performance

BAE Systems is dependent on the skills and capabilities of its people. The Group sets high standards for the training and development of employees, and is a major employer of apprentices and graduates. The Group maintains robust processes for career development including succession planning for its senior executives.

Programme execution is an important and easily recognisable embodiment of performance but, in addition, we target an integrated approach to performance, embracing all aspects of our corporate existence. The Group wants to be recognised as a company committed to developing a culture of Total Performance. Successfully embedding this approach will be a key differentiator for the Group. Total Performance focuses not just on what we do but also how we do it. It is about every aspect of the way we do business, Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour. Delivery of the Group's Corporate Responsibility agenda is an essential part of embedding a Total Performance culture across the Group.

Our focus on safety remains a top priority. The tragic loss of Nimrod XV230 over Afghanistan in 2006 and the subsequent Haddon-Cave report published in October have only strengthened our resolve to continuously

seek improvements to safety across all aspects of our business. The Product Safety Review we recently announced, headed by Nigel Whitehead, Group Managing Director, Programmes & Support, further demonstrates the importance we place on safety. We will work with our customer, the UK Ministry of Defence, to ensure that any learning benefits our current and future workload.

We are also deeply saddened to report the death of one of our employees during deployment of communications equipment in Australia. We are reviewing the cause of this accident and co-operating fully with the regulatory investigation.

BAE Systems aims to achieve leadership standards of responsible business conduct through its programme to address the 23 recommendations of the Woolf Report. As a consequence, we reviewed all Group policies and governance processes during 2009, and have incorporated appropriate changes in the Operational Framework effective January 2010. A further key focus during 2009 was the rolling-out of a Group-wide Code of Conduct for employees as part of the drive to embed high standards of business conduct.

In addition, we have also launched Responsible Trading Principles (see page 5). All trading is to be undertaken in accordance with these principles and consistency of this approach is key in defining BAE Systems' reputation. Together with our global Code of Conduct, these underpin the way we do business.

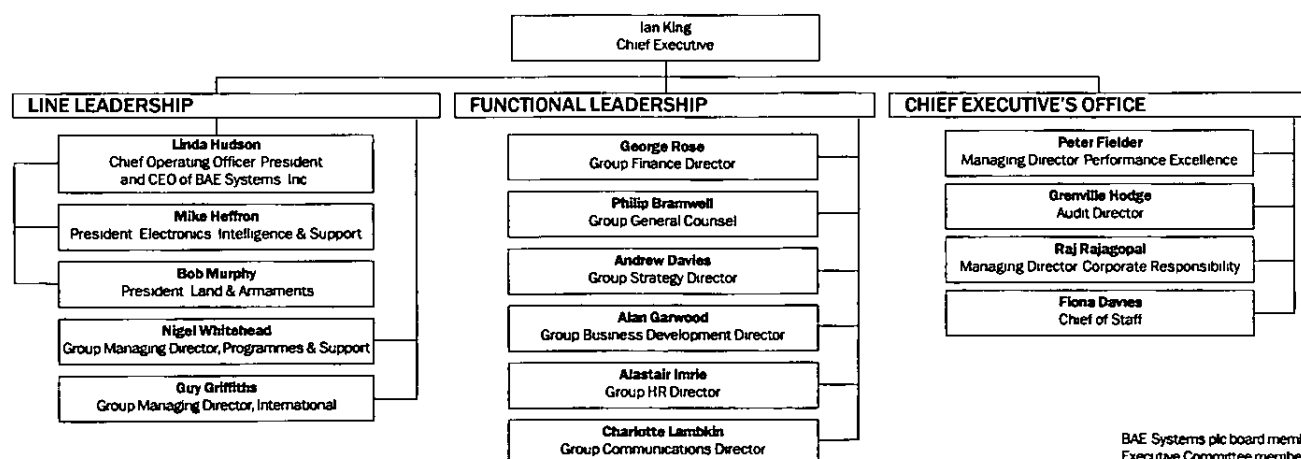
BAE Systems is not complacent and recognises the difficulties in the wider economies in which it operates, but it is a broadly-based and robust business with a large order book. It has been agile in developing the business, adapting its capabilities in anticipation of changing requirements.

The result is a continuously evolving business with a good track record of identifying and exploiting growth opportunities whilst re-focusing the business towards the future priority needs of our customers.

Ian King Chief Executive

OUR EXECUTIVE LEADERSHIP

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.



BAE Systems plc board member
Executive Committee member

PERFORMANCE AGAINST 2009 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

The Board reviews and updates the Group's strategy annually (see page 10). The Chief Executive and Executive Committee agree the Group's Strategic Objective, Strategic Actions and Integrated Business Plans. In addition, there are ten annual objectives agreed by the Chief Executive and Executive Committee which focus on specific deliverables in support of both delivery of short-term results and the overall strategy.

Objective	2009 performance	For more information
1 Meet 2009 financial targets and set challenging and realistic longer-term plans	The Group delivered another year of strong performance, exceeding financial targets for underlying EBITA ¹ and net cash	p30 to 34
2 Further enhance programme execution through schedule and cost performance	Overall, programme execution has been good, as reflected in the strong financial performance of the Group. Targets for programme margin variation and schedule adherence were achieved in the year.	p28
3 Progress towards a recognised leadership position on the Corporate Responsibility agenda	The milestones for the Woolf implementation programme in respect of Group processes and policies, and the global Code of Conduct, were substantively achieved. Revised processes and policies were incorporated in the Operational Framework effective 1 January 2010, and 95% of employees ² were briefed and trained on the Code. The results of an employee survey showed a positive trend in awareness of expected ethical standards.	p29 and p40
4 Drive safety performance to a level comparable with leading performers over a three-year period	The Group exceeded its target to reduce the lost work day case rate by 10% over the gap between 2008 performance and the best in class target, and its target for 60% of major manufacturing sites reaching Level 4 on the Safety Maturity Matrix.	p29 and p40
5 Make progress on the four global Initiatives – Land, Security, Readiness & Sustainment and Unmanned Aircraft Systems	All milestones towards the implementation of the strategic global initiatives were met. Further discussion of these initiatives in the context of the Group's strategy is set out later in this report.	p20 to 21
6 Grow our US business, including execution of planned investments	The Group has reduced its expectations for growth in the US market reflecting increased defence budgetary pressures. In Electronics, Intelligence & Support, the Group remains focused on achieving strategic contract wins in information technology, cyber, mission support and services. In Land & Armaments, the market is expected to provide export opportunities.	p56 to 63
7 Progress delivery of the Saudi Industrialisation Plan and further develop business in the Kingdom of Saudi Arabia	The targets to deliver eight Typhoon aircraft and agree the support solution were achieved. Plans to develop the in-country industrial base to support the modernisation of the Saudi armed forces are progressing.	p70
8 Continue to implement the UK Defence Industrial Strategy (DIS) including execution of our transformation and investment plans	In the air sector, all milestones agreed with the UK Ministry of Defence (MoD) were achieved. In the land sector, the Group continues to develop its strategies for UK vehicle support with the MoD. In the naval sector, the signing of the 15-year Terms of Business Agreement was achieved and the acquisition of VT Group's shipbuilding business completed.	p62 to 63 p66 to 67
9 Progress export opportunities from each of our home markets	The Group continues to successfully address export opportunities. 9% of sales were to destinations outside the Group's home markets in 2009 (2008 12%).	p26
10 Ensure continued quality application of our mandated business policies and processes	The Operational Assurance Statement (OAS) process requires businesses to complete a formal review of compliance with the Operational Framework, including operational and financial controls, and risk management processes, every six months. The Group exceeded its target for an overall improvement in OAS scores.	p29

p96 to 98 FOR MORE INFORMATION ON HOW THE EXECUTIVE COMMITTEE TOP TEN OBJECTIVES RELATE TO EXECUTIVE DIRECTORS' INCENTIVES SEE THE REMUNERATION REPORT

p26 FOR MORE INFORMATION ON THE QUANTITATIVE KPIS USED TO MEASURE PERFORMANCE AGAINST THE EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

p46 FOR MORE INFORMATION ON THE GROUP'S APPROACH TO RISK MANAGEMENT

¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see the Financial review on page 30)
² Wholly-owned subsidiaries only excluding employees on long-term absence

2. Strategy

The Group's Mission is to deliver sustainable growth in shareholder value through Total Performance

Strategic review	10
Market review	16
Global initiatives	20
Strategy in action	22

BAE SYSTEMS SURFACE SHIPS

Bringing BVT Surface Fleet into full ownership further strengthened the Group's global maritime business. The acquisition was accompanied by a 15-year Terms of Business Agreement with the UK Ministry of Defence. The agreement will sustain key industry capabilities in the UK, and provide a strong platform on which to build future domestic and international business.

STRATEGIC REVIEW

A consistent and well-defined strategy focused on defence, security and aerospace capabilities

Our Vision is to be the premier global defence, security and aerospace company

Our Mission is to deliver sustainable growth in shareholder value through our commitment to Total Performance for all our customers

Our Strategy

Our Group Strategic Objective is Total Performance through

Customer
Focus

Financial
Performance

Programme
Execution

Responsible
Behaviour

Our Values are Trusted, Innovative and Bold

Strategic Actions

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

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

Establish in the UK sustainably profitable through life business in air, land and sea

Grow our home markets in the Kingdom of Saudi Arabia, Australia and India

Implement our global initiatives in Security, Readiness & Sustainment and Unmanned Aircraft Systems

Continue to develop our global markets

Integrated Business Plans

The Group continues to deliver on a consistent, well-defined strategy. The Group has refreshed its **Vision** – to be the premier global defence, security and aerospace company. The **Mission** remains to deliver sustainable growth in shareholder value through a commitment to Total Performance.

The Board and Executive Committee focus close attention on the Group's Strategy. Positioning to optimise the business in the current environment, the Group Strategic Framework continues to develop to recognise progress against the strategic objectives, and to highlight the Group's focus on delivery and performance.

The Group Strategic Objectives have been replaced with a single **Group Strategic Objective** – to deliver Total Performance. Representing the

commitment to Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour, Total Performance enables the Group to be agile in developing the business, and adapting its capabilities to the changing priorities of customers.

To drive the strategy forward and deliver its full potential, the Group is focused on six Group **Strategic Actions** (previously referred to as Business Portfolio Actions) which emphasise the home market strategies, the need to drive efficiencies across the business and the continued development of four global initiatives – Land, Security, Readiness & Sustainment and Unmanned Aircraft Systems. The Group's Strategic Action to grow in the Kingdom of Saudi Arabia has been expanded this year to include Australia and our seventh home market, India.

Integrated Business Plans from across the business are used to deliver the Strategic Actions.

The Group's culture depends on its employees all living its **Values** – Trusted, Innovative and Bold. They are an essential element of developing a culture of Total Performance. The Group asks employees to demonstrate the values in their day-to-day work. They are an important indicator of the company the Group believes it can be.

The Group believes an enduring set of values enables it to be agile and adaptive in its strategy, and clearly guides the behaviours wanted in all its employees. With so many businesses across the world, a strong set of shared values and a global Code of Conduct bind the Group together and underpin the delivery of its strategy. To this end, these values have been incorporated into the Group Strategic Framework.

continuing to develop a culture of Total Performance...

2010 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

The Executive Committee has set the following objectives for 2010. A review of performance against these objectives will be contained in the Annual Report 2010. The aim of these objectives is to provide focus for the leadership and engagement of people at all levels in the Group.

Objective

1. Meet 2010 financial targets, and set challenging and realistic longer-term plans
2. Further enhance programme execution through cost performance
3. Focus on our commitments to our customers through schedule performance
4. Progress towards recognised leadership position in responsible behaviour
5. Grow our Electronics, Intelligence & Support business both organically and via acquisitions, and improve efficiency
6. Implement our global land systems strategy, and deliver on our efficiency and rationalisation plans
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

p16 FOR MORE
INFORMATION
ABOUT OUR
MARKETS

p20 FOR MORE
INFORMATION
ON OUR GLOBAL
INITIATIVES

p22 FOR MORE
INFORMATION
ON OUR STRATEGY
IN ACTION

LEADERSHIP IN CORPORATE RESPONSIBILITY

Corporate Responsibility (CR) is an integral part of BAE Systems' Total Performance approach.

Responsible business conduct and delivery of our CR agenda are essential to achieving long-term sustainable growth. For example, achieving strong leadership performance on responsible business conduct, safety, and diversity and inclusion will contribute to improved efficiency and productivity, and enhance our reputation with customers, employees and other stakeholders.

At BAE Systems, we take the same rigorous approach to CR as we do for our customer projects. This ensures that we embed CR as part of our employees' day-to-day jobs and drive continual progress.

p38 FOR MORE INFORMATION ON
CORPORATE RESPONSIBILITY
ALTERNATIVELY
~ SEE OUR CR REPORT
~ OR VISIT
[WWW.BAESYSTEMS.COM/
CORPORATERESPONSIBILITY/](http://WWW.BAESYSTEMS.COM/CORPORATERESPONSIBILITY/)

...through focused investment and

TARGETED INVESTMENTS RE-SHAPING THE BAE SYSTEMS BUSINESS

Following the merger of British Aerospace plc and GEC's Marconi Electronic Systems business in 1999, the Group has grown and developed through improvements in business performance, organic growth, and targeted acquisitions and disposals. Over the last ten years, the Group has invested over £7.5bn in the acquisition of defence and security businesses consistent with delivery against clear strategic objectives. These acquisitions have, in part, been financed by strategic business disposals with proceeds exceeding £2.5bn.

ACQUISITIONS AND DISPOSALS (CUMULATIVE £BN)

Electronics, Intelligence & Support The acquisition in 2000 of two former Lockheed Martin businesses, Control Systems and Aerospace Electronics Systems, established the Group as a world leader in digital engine controls, flight controls and electronic warfare solutions.

Land & Armaments The acquisitions of Alvis in 2004, United Defense in 2005 and Armor Holdings in 2007 were key to the Group establishing a global land systems business.

Programmes & Support The acquisition of Detica in 2008 provided access to government security business. The acquisition of VT Group's shipbuilding business has further strengthened the Group's global maritime business.

International The acquisition of Tenix Defence in 2008 positioned the Group as Australia's largest defence contractor.

Note: Only major acquisitions and disposals are individually named.

UNDERLYING EARNINGS¹ PER SHARE (PENCE)

An active programme of targeted acquisitions and disposals has contributed towards the re-shaping of BAE Systems as a high performing business.

1. Financial years 2000 to 2003 prepared under UK GAAP (underlying earnings exclude goodwill amortisation and impairment, and exceptional items). Financial years 2004 to 2008 prepared under IFRS (underlying earnings exclude amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories). In 2009, underlying earnings, prepared under IFRS, exclude amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see the Financial review on page 30).

programme diversity...

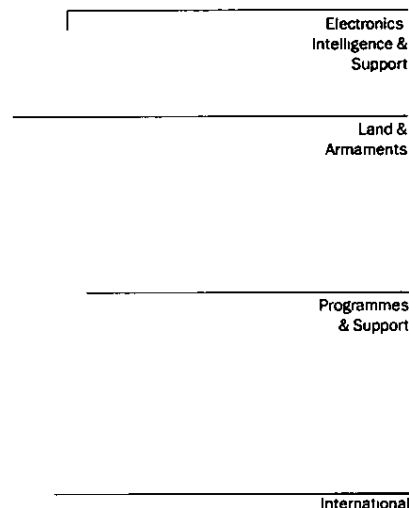
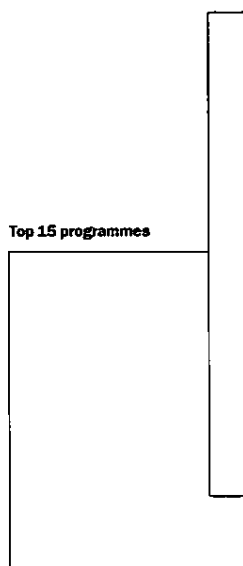
WELL-BALANCED SPREAD OF PROGRAMMES BY OPERATING GROUP

Excluding the share of the order book of Airbus, the Group's 20% share in which was sold during 2006, the Group's order book has grown from £25.0bn in 2000 to £46.9bn at the end of 2009. As illustrated below, 51% of this is represented by the Group's top 15 programmes and the remaining 49% is spread across the four operating groups. Many of these programmes are conducted under long-term contracts, and a substantial proportion includes the provision of through-life capability and support. The diverse range of programmes provides the Group with a broad business base.

Whilst the Group's US businesses are engaged in significant multi-year contracts, these contracts typically provide that performance beyond the first year is contingent upon the receipt of funding. The US government typically authorises funding on an annual basis and incremental orders are, therefore, recorded as funding is received.

ORDER BOOK^{4,5} 2009 TOP 15 PROGRAMMES

ORDER BOOK^{4,5} 2009 REMAINING PROGRAMMES



Programme	Description	Customer	Year of award	Duration (years)
Typhoon Tranche 2 Aircraft	Manufacture of 236 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain	2004	10
Typhoon Tranche 3A Aircraft	Manufacture of 88 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain	2009	7
Queen Elizabeth Class Aircraft Carriers	Design and manufacture of two 65,000 tonne aircraft carriers	UK Royal Navy	2008	10
Astute Class Submarines	Design and manufacture of nuclear-powered attack submarines	UK Royal Navy	1997	25 ²
Tornado ATTAC	Availability service for Tornado aircraft including maintenance, support and training	UK Royal Air Force	2006	10
Type 45 Destroyers	Design and manufacture of six Type 45 anti-air warfare destroyers	UK Royal Navy	2007 ³	5
Nimrod MR4 Production	Manufacture of nine Nimrod Maritime Reconnaissance Aircraft	UK Royal Air Force	2006	6
Saudi Typhoon Aircraft¹	Supply of 72 Typhoon combat aircraft	Royal Saudi Air Force	2007	11
Landing Helicopter Dock	Design, production and supply of two amphibious Landing Helicopter Dock ships	Royal Australian Navy	2007	9
Saudi role equipment	Delivery of equipment and training	Royal Saudi Air Force	2009	4
Saudi Typhoon Support¹	Availability contract for first squadron of Typhoon aircraft including maintenance, support and training	Royal Saudi Air Force	2009	3
Saudi British Defence Co-operation Programme	Provision of support to operational capability	Royal Saudi Air Force/Royal Saudi Naval Force	2007	5
Family of Medium Tactical Vehicles	Manufacture of approximately 20,000 tactical trucks and trailers	US Army	2008	3
Munitions Acquisition Supply Solution	Capability provision and manufacture of general munitions	UK Army	2008	15
Bradley A3 Re-manufacture	Re-manufacture and upgrade of 578 Bradley Fighting Vehicles	US Army	2008	3

1 The appropriate work share of the Saudi Typhoon Aircraft and Support contracts is reported within Programmes & Support.

2 Assuming a full seven-boat programme.

3 Contract award in 2000 but re-negotiated in 2007 as a six ship contract.

4 Including share of equity accounted investments' order books and before the elimination of intra-group orders.

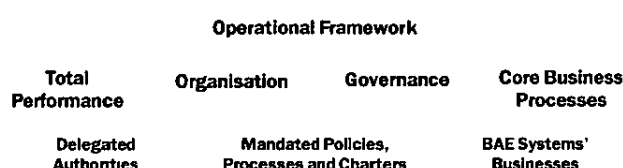
5 Excluding HQ & Other Businesses.

...underpinned by essential resources...

The Group's key resources and arrangements include the people it employs, its relationships with customers, subcontractors and other suppliers, 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.

OUR OPERATIONAL FRAMEWORK

The Operational Framework sets out how the Group will meet its Group Strategic Objective of achieving Total Performance, which together with its values, underpins the Group's ability to deliver the strategy. It is mandatory across all wholly-owned and majority-owned businesses, and describes the Group's approach to Total Performance, organisation, governance, core business processes, mandated policies, processes and charters, and delegated authorities.



p81 FOR MORE INFORMATION ON OUR OPERATIONAL FRAMEWORK

OUR PEOPLE

The contribution of the Group's employees is fundamental to its success. The Group's workforce encompasses the broad spectrum of skills and experience needed to deliver its products and services.

- Lost work day case rate reduced by 33% against target in 2009
- Global Diversity Working Group launched in 2009
- Over 10,000 courses available online
- 283 new apprentices employed in the UK in 2009
- Approximately 92,000 employees have shares in BAE Systems plc

Safety

The Group's commitment to embed a safety culture contributes to strong employee relations and business performance.

Diversity and inclusion

The People Policy in the Operational Framework obliges each employee to contribute to the creation of an inclusive work environment where individuals are respected and the value of having a diverse workforce is recognised. 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 accommodations to disabled people employed by the Group. Unlawful discrimination against individuals with disabilities is not tolerated. This policy is subject to relevant legislative, regulatory and security requirements. Diversity and inclusion are included in the performance objectives for senior leaders.

Capability development

Training and development help the Group to deliver world class business performance and service excellence, keep up with changing technology and meet customers' needs. A culture of life-long learning is encouraged through flexible training and development tools for employees at all levels.

Developing leadership capability

The Total Performance Leadership (TPL) process drives business success by linking individuals' goals with the wider goals of the organisation. TPL includes objective setting, performance assessment, and the determination of reward, development needs and potential.

Education and early careers

The Group works in partnership with education providers in its home markets to facilitate a continued supply of talented and qualified graduates and apprentices for its early career programmes. The Group supports education schemes with an emphasis on science, technology, engineering and mathematics.

Employee engagement

The Group engages regularly with employees via employee representative bodies and trade unions, meetings, employee surveys, global, regional and departmental newsletters, and a global intranet site. The effectiveness of this communication is assessed regularly. Employees are encouraged to become shareholders in the Group by way of employee share schemes.

p44 FOR MORE INFORMATION ON OUR WORKPLACE

p29 FOR MORE INFORMATION ON OUR CODE OF CONDUCT AND SAFETY KPIS

OUR CUSTOMERS

Customer Focus is a key element of the Group Strategic Objective of Total Performance.

– Targeted improvement in schedule adherence achieved

The Group's core businesses are mostly defence-related, selling products and services primarily in its home markets and to other national governments, both directly and indirectly through other defence and aerospace companies. In many cases, these relationships 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.

Throughout the product and project lifecycles, the Group engages extensively with its customers and undertakes customer satisfaction surveys as part of its drive for continuous performance improvement, aligning with the Group Strategic Objective of Total Performance.

The Group's largest customers are the governments of the United Kingdom, United States, Kingdom of Saudi Arabia and Australia. In the US, BAE Systems is subject to the 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. 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. 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.

Delivery of the Group's corporate responsibility agenda supports its reputation and contributes to successful long term relationships with customers. Our commitment to be recognised as a leader in responsible business conduct and to achieve leadership safety performance is particularly important.

Lifecycle Management (LCM), which is mandated under the Operational Framework, provides a structured approach to managing the Group's commitments and investments throughout product and project lifecycles, promoting the application of best practice management and facilitating continuous improvement. Programme margin variation and schedule adherence are regularly reviewed to monitor contract profitability and milestone achievement.

p28 FOR MORE INFORMATION ON OUR PROGRAMME MARGIN VARIATION, SCHEDULE ADHERENCE AND CUSTOMER SATISFACTION KPIS

OUR SUBCONTRACTORS AND OTHER SUPPLIERS

Expenditure on subcontracts can represent a significant portion of project cost, with effective management of this expenditure being a key value driver for the Group.

- Managing major subcontractors is a key strategic capability
- Top 1,000 suppliers to be provided with the Group's global Code of Conduct and encouraged to work to equivalent standards
- Global database of at-risk suppliers compiled in 2009

The benefits of capability-based contracting, combined with ongoing budget pressures, have led many customers to demand a more integrated partnering approach to meet their requirements. Best practice in managing major subcontracts is embedded in the Group's processes, guidance and training to help deliver on commitments to customers, aligning with the Group's Strategic Objective of Total Performance through programme execution.

Managing relationships with suppliers is an essential part of developing systems integration and through-life management capabilities. The Group is committed to improving supply chain relationships and working together with other companies, large and small, in each of its home markets to deliver better value and innovation for its customers.

This year, an additional principal risk relating to the Group's dependence on component availability, subcontractor performance and key suppliers has been disclosed. In light of global economic conditions, the Group has reviewed strategically important suppliers globally to assess their financial health.

The performance of the suppliers we work with could potentially impact the Group's reputation and financial performance, and we are putting measures in place to encourage high standards of corporate responsibility in our supply chain.

p49 FOR MORE INFORMATION ON OUR RISK RELATING TO COMPONENT AVAILABILITY, SUBCONTRACTOR PERFORMANCE AND KEY SUPPLIERS

p43 FOR MORE INFORMATION ON OUR SUPPLY CHAIN

OUR RESEARCH AND DEVELOPMENT (R&D)

The Group is engaged in significant R&D programmes in support of the platforms, systems, services and capabilities that it provides to its customers.

- 2009 R&D expenditure was £1,153m (2008 £1,044m), of which £220m (2008 £211m) was funded by the Group.

The Group's R&D activities cover a wide range of programmes and include performance innovations, improvements to manufacturing techniques and technology to improve through-life support of products.

The Group funds strategic R&D across the business, particularly in the Electronics, Intelligence & Support operating group, and the four global initiatives of Land, Security, Readiness & Sustainment and Unmanned Aircraft Systems. Customers fund directly much of the near-term product development work undertaken by the Group.

BAE Systems has launched an investment partnership aimed at small and medium sized enterprises and academia to identify new technologies, and help bring them to market. As well as providing financial support, BAE Systems offers expertise and resources, such as the use of test and evaluation facilities. Current projects focus on the areas of cybersecurity and biometrics.

OUR INTELLECTUAL PROPERTY

The Group's intellectual property can make a significant contribution to its competitive advantage.

- The Group filed patent applications covering over 250 new inventions in 2009.
- BAE Systems now has a total portfolio of patents and patent applications covering approximately 2,000 inventions internationally.

Intellectual property is created every day, taking many forms, both in tangible products and 'know how'. The Operational Framework mandates a policy to protect the Group's intellectual property 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.

MARKET REVIEW

...ensuring strong market positions.

GLOBAL DEFENCE MARKET

The global defence market is expected to become increasingly challenging with government budgets under pressure following the financial crisis and increased levels of uncertainty. This is set against a backdrop of ongoing operational commitments and the need to drive acquisition reform.

Building on our global, multi-home market presence, leveraging our knowledge of our customers, our understanding of their requirements and our past performance, the Group has the capabilities and strategic flexibility to respond to the challenges of the global defence market.

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

In constant 2008 prices

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

Top ten global defence companies (based on 2008 defence revenues)

Whilst the difficult economic climate is expected to restrict governments' spending, 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.

In 2008, BAE Systems was the second largest global defence supplier, up from third in 2007. This represented an expansion of business in the Group's home markets and export markets.

ACCESSIBLE DEFENCE MARKETS (US\$BN)

Top 11 markets accessible for business by the Group (based on 2008 total defence expenditure)

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

Top ten US defence companies (based on 2008 Department of Defense expenditure)

The US continues to dominate global defence expenditure. It is estimated to account for approximately 44%¹ of the world's total defence expenditure in 2008. As a major supplier in the US market, BAE Systems is well positioned to capture returns from this market.

In 2008, BAE Systems was the fourth largest supplier to the US Department of Defense (DoD), up from sixth in 2007.

¹ Based on BAE Systems' internal analysis

A GLOBAL, MULTI-HOME MARKET PRESENCE

BAE Systems continues to deliver its strategy in selected home markets with attractive, sustainable opportunities to develop an industrial presence. Embedded as a key part of the defence industrial base, with strong customer relationships, BAE Systems is able to deliver capability as a domestic supplier in its established home markets.

US The US remains the world's largest single defence market, estimated to account for approximately 44% of global defence spending in 2008. Having experienced exceptional annual growth rates between 2001 and 2009, growth in the US defence budget is now expected to slow. The President's 2011 budget request to Congress provides for a 7.7% increase in the procurement budget and a 3.4% overall increase in spending.

BAE Systems is well positioned to support its customers in their changing programme priorities across the four domains of air, land, sea and cyber. BAE Systems continued to gain market share in 2008 and develop as a major supplier to the defence industrial base, being ranked number four among the leading suppliers to the US Department of Defense (see chart opposite).

As a leading supplier of defence electronics, BAE Systems remains focused on achieving growth through strategic contract wins in information technology, cyber, mission support and services. The Group is capitalising on its positions in electronic warfare and infrared technologies, and a diverse mix of commercial and civil government businesses in such areas as ship repair, information technology and commercial aviation.

Although the land market is expected to be impacted by changing priorities and decreases in operational tempo, the US Combat Systems business continues to focus on its domestic US customer through supporting the legacy product base.

Positioned to capture emerging markets, the Group has leveraged internal expertise and focused internal investment to ensure innovative solutions in cybersecurity. The Group identifies power management as an emerging opportunity.

UK Market conditions will continue to be challenging and uncertain whilst awaiting the nature and shape of defence priorities that the expected 2010 Strategic Defence Review will provide. The Group continues to position itself to ensure a sustainably profitable through-life business across the air, land and sea domains.

In the air sector, the UK business secured the production contract for Typhoon Tranche 3A, which extends visibility of production for the next five years. In the surface ship domain, a 15-year Terms of Business Agreement has been agreed with the UK Ministry of Defence, which sets out lead roles for the business on defined surface shipbuilding and support programmes.

Moving forward to capture new elements of the market, the Programmes & Support operating group secured over £3bn of support contracts in 2009. In addition, following the acquisition of Detica in 2008, the Group is positioned to gain scale in the security sector as budget priorities continue to emphasise intelligence and resilience capabilities.

Australia In 2009, the Australian government released its Defence White Paper, 'Force 2030', which sets out the Australian Defence Force's (ADF) plans for substantial platform and technology acquisitions. The Australian government has committed to real growth in the defence budget of 3% to 2017-18, with further growth beyond.

Following the acquisition of Tenix Defence in 2008, BAE Systems is the industry leader in the significant and growing Australian defence market.

To help the Australian government meet its plans, BAE Systems Australia is committed to becoming the leading through-life capability partner to the ADF. Combining key skills in engineering and systems integration, BAE Systems is a leading provider of communications, electronic warfare systems, military air support, air defence, mission support systems, land combat systems, maintenance, garrison support and intelligence, surveillance and reconnaissance.

Kingdom of Saudi Arabia The Kingdom of Saudi Arabia is expected to remain a growing market, defence spending accounting for approximately 7.7% of Gross Domestic Product (GDP) in 2008.

The Kingdom of Saudi Arabia remains a key home market for BAE Systems. Continuing its commitment to the country, the Group has increased the proportion of Saudi nationals employed in the business and made further investment in facilities in-country. Through technology transfer, focused investment, training and support, BAE Systems' intention is to establish credible and sustainably profitable local suppliers to the Saudi armed forces.

Sweden The Swedish defence budget is expected to remain at around 1.4% of GDP through to 2012. However, cuts to defence procurement are forecast and the Group's Swedish business has restructured to align with anticipated future customer requirements.

Within this context, BAE Systems continues to retain a leading position in the Swedish domestic land market. Core growth opportunities remain focused on products which support the Group's export propositions and global land business, including the CV90 infantry fighting vehicle.

South Africa Foreign investment in defence continues to be actively encouraged by the government of South Africa and defence is a priority for the country. Supporting the growing international requirement for mine protected vehicles, South Africa remains a hub of innovation and engineering for the Group's land business.

India The Indian government has a strong commitment to national defence, an increasing openness to foreign participation and significant requirements for new defence equipment. Against this backdrop, India became the Group's seventh home market in 2009. Indian defence spending increased by an estimated 34% between 2008 and 2009. Further increases to the budget are expected. This is supported by strong forward growth projections for India's GDP and a public commitment to the transformation of the Indian armed forces. While the government of India remains committed to developing its defence industrial base, it continues to source approximately 70% of its equipment from foreign suppliers and recognises the requirement for partnership to meet its domestic ambitions.

The Group has re-affirmed its long-term commitment to the market, and is working to develop opportunities to support India's emerging defence and security requirements.

Developing a multi-market business...

Our global business is based around seven home markets in Australia, India, Saudi Arabia, South Africa, Sweden, the UK and the US. These markets are identified as having a significant and sustained commitment to defence and security, and an openness to foreign investment to develop 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, thereby providing a foundation for long-term investment and growth.

Advisory boards have been established to advise on the development of business in Saudi Arabia, India and Oman. The advisory board for each territory typically consists of experts in the particular region who are external to the Group.

UNITED STATES

Market overview

- Defence expenditure of approximately \$667bn (£413bn), the world's single largest defence market¹
- Defence spending of approximately 4.6% of Gross Domestic Product (GDP)¹

BAE Systems' position

- The fourth largest supplier to the US Department of Defense¹
- The Group is a premier supplier to the US Army and a leading supplier of defence electronics to the US government
- 126 business locations across 38 states²

43,700

Employees³

SOUTH AFRICA

Market overview

- Defence expenditure of approximately \$3.4bn (£2.1bn)¹
- Defence spending of approximately 1.2% of GDP¹

BAE Systems' position

- The number three defence supplier¹
- The Group is a leader in land systems
- 4 business locations across the country²

600

Employees³

1 Based on 2008 data
2 Excluding equity accounted investments and customer locations
3 Excluding the Group's share of equity accounted investments

UNITED KINGDOM

Market overview

- Defence expenditure of approximately \$67bn (£41bn)¹
- Defence spending of approximately 2.5% of GDP¹

BAE Systems' position

- The largest supplier to the UK Ministry of Defence¹
- The Group has market leadership positions across the air, land and sea sectors
- 57 business locations across the country²

40,400

Employees³

SWEDEN

Market overview

- Defence expenditure of approximately \$6.7bn (£4.1bn)¹
- Defence spending of approximately 1.4% of GDP¹

BAE Systems' position

- The number two in-country defence supplier in the Swedish market¹
- The Group is a key domestic defence manufacturer and the leading supplier of land systems
- 5 business locations across the country²

1,500

Employees³

SAUDI ARABIA

Market overview

- Defence expenditure of approximately \$36bn (£22bn)¹
- Defence spending of approximately 7.7% of GDP¹

BAE Systems' position

- The leading in-country defence supplier
- The Group provides support to the operational capability of the Royal Saudi Air, Land and Naval Forces
- 1 business location², plus presence at 7 customer locations

4,900

Employees³

INDIA

Market overview

- Defence budget of approximately \$24bn (£15bn)¹
- The Indian defence budget grew by 34% in 2009

BAE Systems' position

- A new home market in 2009
- The Group is investing in an in-country industrial presence, initially focusing on its land capabilities

AUSTRALIA

Market overview

- Defence expenditure of approximately \$22bn (£14bn)¹
- Defence spending of approximately 2% of GDP¹

BAE Systems' position

- Australia's largest defence contractor¹
- The Group is a leading provider of mission systems, air defence, land combat systems, maintenance, garrison support and intelligence, surveillance and reconnaissance
- 24 business locations across the country²

6,100

Employees³

GLOBAL INITIATIVES

...supported by our global initiatives...

The Group has four global initiatives in Land, Security, Readiness & Sustainment and Unmanned Aircraft Systems. These provide an important focus for the transfer of best practice across its home markets, leveraging appropriate skills and capabilities to meet the requirements of its customers, and grow the business.

LAND

The objective of the land initiative is to create and sustain a global land business, leveraging the Group's capabilities and its home market strategy to achieve a pre-eminent position in selected markets.

RG35 - BAE Systems continuously develops vehicles to support its customers' operational needs. The new RG35 mine protected multi-purpose fighting vehicle, developed by the Group's Land Systems South Africa business and launched during 2009, combines high levels of survivability with the tactical capability of a modern combat vehicle.

The land initiative was launched in 2008 following the acquisitions of Alvis (in 2004), United Defense (in 2005) and Armor Holdings (in 2007). The Group's Land & Armaments operating group has moved from a confederation of acquired businesses to an integrated global business.

Global opportunities are pursued through all of the Land & Armaments operating group's lines of business. The strategy places increased importance on leveraging the Group's positions in Saudi Arabia, Australia and India.

The Group's land sector business is adapting its business model for agility, flexibility and responsiveness. It is adjusting its product offerings to match the procurement priorities and order sizes of the global customer base. By realigning the business and tightly controlling costs, the land business remains a sustainable enterprise with a balanced risk profile that delivers shareholder value.

The global businesses are investing in product offerings designed to provide unparalleled performance capabilities for competitive prices. The diversification of the Group's land portfolio, coupled with its adaptive strategy, enables flexibility and agility in the marketplace.

p60 FOR MORE INFORMATION ON OUR
LAND & ARMAMENTS OPERATING GROUP

SECURITY

The emerging security strategy concentrates on helping the Group's government and private sector customers strengthen border and transportation security, develop cybersecurity, and combat terrorism and organised crime.

Following the 2008 Executive Committee objective to progress development of the Group's home market security businesses and resulting acquisition of Detica in 2008, BAE Systems launched a global security initiative to address the global security market. Security encompasses intelligence and resilience, and can be understood as the collection of technologies and services which detect, monitor, deter and defeat potential threats to civilian welfare.

The Group is focusing on its home markets, with significant emphasis on the US, UK and Australia, but also the emerging home markets in India and the Kingdom of Saudi Arabia. In each of these markets, the Group has an opportunity to work with its customers in a position of trust throughout the lifecycle of their programmes – from consultancy to large scale systems integration.

Significant progress has been made during 2009. The Electronics, Intelligence & Support operating group made investments to increase its cybersecurity capabilities for the US government, establishing a leading edge Network Operations Centre. In the UK, a team from across Programmes & Support won a significant security programme for a government client. BAE Systems Australia is working with Detica to pull through data analysis technologies, and develop a distinctive position in the Australian market for security-related services and solutions.

In 2010, the Group plans to accelerate growth in this important sector, strengthening its large-scale information technology, solutions integration and managed services capabilities, and working closely with government and industry partners to address emerging trends.

Detica NetReveal® - The Detica NetReveal® solution for detecting fraud and organised crime has continued to show global sales growth. It is used by banks and insurers, government and law enforcement agencies.

p67 FOR MORE INFORMATION ON
OUR DETICA SECURITY BUSINESS

READINESS & SUSTAINMENT (R&S)

The R&S initiative focuses on the growing worldwide market for third party platform and systems support. This is an area of opportunity in all of the Group's home markets.

R&S encompasses and expands upon traditional support activities. It can be defined as the range of activities used in the preparation of a force to a mission-ready state and the support of this force (during preparation for military operations, the operations themselves and in their aftermath) over a period of time, potentially through life.

Through-life support has long been a differentiating value proposition for the Group, offsetting the variability in equipment procurement budgets, and the Group has an innovative range of R&S tools, processes, capabilities and contracting approaches. Product support services and associated R&S represented approximately 40% of 2009 sales for BAE Systems.

The R&S initiative was launched in 2009 to explore opportunities for extracting further growth from the global R&S market by leveraging the Group's established R&S services in new geographies and sectors.

Specifically, the Group aims to position for third party support, move up the value chain, and maximise and defend the Group's original equipment manufacturer R&S position. Through tailored integration of its R&S services and cross business collaboration, BAE Systems is well placed globally to extend its footprint in R&S services to a wider range of products and platforms.

The R&S initiative is moving into its implementation phase and the lines of business are positioned to accelerate growth in this key market.

Type 45 – BAE Systems multi-year contract, awarded in 2009 by the UK Ministry of Defence, will deliver in-service support to the Type 45 anti-air warfare destroyers.

UNMANNED AIRCRAFT SYSTEMS (UAS)

The UAS initiative aims to deliver tangible business opportunities in each of the Group's home markets, enabling specialist teams to leverage the best of BAE Systems' global capability for its customers, and to provide a route into the international market for its UAS products and services.

Mantis – The next generation autonomous system, Mantis, completed its maiden flight in Woomera, South Australia, in October. Mantis, an advanced technology demonstrator medium-altitude long-endurance UAS, went from concept to flight in just 19 months.

The clear drivers for the UAS strategy, launched in 2008, were the opportunities that the global market for UAS presented for the Group's new and existing capabilities.

The UAS initiative ensures a collaborative approach to sharing expertise, technology and best practice across the Group's home markets.

BAE Systems is at the forefront of autonomous technologies and continues to develop complete integrated systems, such as Herti, Mantis and Taranis in the UK, as well as critical systems capabilities and technologies in ground station and mission systems in the UK and US, and autonomous flight control systems in Australia.

In June, BAE Systems acquired Advanced Ceramics Research, Inc in the US, which provides three small and tactical UAS platforms (the Coyote, Silverfox and Manta), as well as related support capabilities.

Key customer programmes that are critical to executing the UAS initiative in each home market have been identified and the strategy is being aligned across the respective businesses.

Together with the other global initiatives, the UAS initiative is targeted to deliver tangible business opportunities and long-term growth for the Group.

STRATEGY IN ACTION

...and delivering performance from key growth opportunities.

The following case studies describe examples of BAE Systems' drive for continuing performance improvements whilst meeting the changing needs of its customers

DRIVING GROWTH FROM INNOVATION

In the US, the Group's Electronics, Intelligence & Support (EI&S) operating group is a focus for much of the Group's research and development investment and is a leader in the development of many advanced technologies. It has an excellent track record of innovation and leveraging new business opportunities from the application of technology.

As an example, BAE Systems has developed a range of high-precision solid state micro-bolometers (photon detectors). These chip-based detectors are manufactured at the Group's in-house foundry and are used in a range of multi-spectral sensing products, including thermal weapon sights.

In September, BAE Systems was one of two companies selected to participate in a programme to meet a requirement for a system of sensors to provide 24-hour all-weather visibility to operators of military armoured ground vehicles. The Group has developed a solution that includes placing cameras, utilising the solid state detector technology, inside the vehicle light clusters. The Driver's Vision Enhancer Family of Systems gives the vehicle occupants a surveillance and situational awareness capability in darkness or reduced visibility caused by fog or smoke. The solution is highly cost effective and requires minimal change to the vehicle and its armour structure.

In addition to developing high growth potential business from technologies, such as multi spectral sensing, BAE Systems also identifies growth from advanced power management technology. It has already supplied more than 2,000 hybrid electric drive systems, forming part of integrated power management systems for urban transit buses.

Driver's Vision Enhancer Family of Systems

NAVAL SECTOR INDUSTRIAL STRATEGY

The establishment of an industrial strategy for UK naval shipbuilding has been an important element in securing long-term stability for that sector.

PRINCIPAL SURFACE SHIP PROGRAMMES

TYPE 45

HMS DARING
HMS DAUNTLESS
DIAMOND
DRAGON
DEFENDER
DUNCAN

QUEEN ELIZABETH CLASS CARRIERS

QUEEN ELIZABETH
PRINCE OF WALES

A FUTURE SURFACE COMBATANT CONCEPT

In October, BAE Systems completed the acquisition of VT Group's 45% shareholding in BVT Surface Fleet. The acquisition followed an agreement with the UK Ministry of Defence in July defining a Terms of Business Agreement setting out a 15-year partnering arrangement, including lead roles for the business on defined surface shipbuilding and support programmes.

In December 2008, the first of six Type 45 anti-air warfare destroyers, HMS Daring, was accepted off contract and the second ship, HMS Dauntless, in December 2009. Production of Type 45 continues through to 2012.

In July, first steel was cut for the Royal Navy's new class of two 65,000 tonne aircraft carriers following award of manufacturing contracts in July 2008. The aircraft carrier programme is a significant element of the workload covered by the Terms of Business Agreement.

Looking beyond the Carrier programme, the Group is engaged on a concept design for the UK Future Surface Combatant programme, due to enter service around the end of the next decade to replace the Royal Navy's Type 23 frigates.

COMBAT AIRCRAFT GROWTH

BAE Systems is entering a phase of growth in its combat aircraft activities. The Group has an unrivalled position on both sides of the Atlantic with concurrent participation on two new generation tactical combat aircraft programmes underway

ACTUAL/EXPECTED TYPHOON AIRCRAFT DELIVERIES

The Typhoon combat aircraft programme is set for increased deliveries. The programme is transitioning from the approximately 36-a-year production rate under the first, Tranche 1, phase to the planned 50-a-year rate for Tranche 2, including deliveries to the Kingdom of Saudi Arabia

With the signing of contracts in 2009 to launch Tranche 3, the third phase of the programme, deliveries to the four European partner nations are contracted through to 2015. In addition, Typhoon aircraft deliveries on the Saudi programme extend to 2017. Typhoon export opportunities are being pursued in a number of other markets

ACTUAL/EXPECTED F-35 AIRCRAFT DELIVERIES

BAE Systems is a significant participant on the Lockheed Martin-led F-35 Lightning II programme, manufacturing aft airframe and empennage products in the UK, supplying air vehicle systems through its UK supply chain, and electronic warfare and flight control systems supplied from the Group's US operations

The very large scale requirement for F-35 aircraft includes replacement of many combat aircraft types currently in service in the US with significant numbers of aircraft in the current fleets reaching the end of their operational lives throughout the next decade

The F-35 programme is expected to progress towards a production rate of approximately 200 aircraft a year to meet demand in the US and around the world. In addition to the valuable business expected from production of these aircraft over many years, BAE Systems will also participate in their through-life support

3. Group performance

The Group Strategic Objective is Total Performance through Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour

Key Performance Indicators (KPIs)	26
Financial review	30
Corporate Responsibility review	38
Risk management	46
Principal risks	48

ASTUTE CLASS SUBMARINE

Astute is the most advanced attack submarine ever supplied to the Royal Navy, incorporating the latest stealth technology combined with an advanced sonar system. She is designed to fulfil a range of key strategic and tactical roles including anti-ship and anti-submarine operations, surveillance and intelligence gathering, and support for land forces.

KEY PERFORMANCE INDICATORS (KPIs)

The Board uses a range of financial and non-financial performance indicators, reported on a periodic basis, to monitor the Group's performance over time. Executive directors' remuneration is linked to certain of these measures, including Earnings per Share, cash flow, business conduct and safety performance.

Financial Performance

Financial KPIs are used to measure financial performance which underpins the Group's Strategic Objective of Total Performance, its Strategic Actions and Integrated Business Plans

Link to 2009 Executive Committee top ten objectives

- 1 Meet 2009 financial targets, 5 Make progress on the four global initiatives, 6 Grow our US business, including through investments
- 7 Progress the business in the Kingdom of Saudi Arabia,
- 8 Continue to implement the UK Defence Industrial Strategy,
- 9 Progress export opportunities

p7 FOR MORE INFORMATION ON OUR 2009 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

Description

ORDER INTAKE¹ (£BN)

Order intake¹ 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.

SALES¹ (£BN)

Sales¹ represents the amounts derived from the provision of goods and services, and includes the Group's share of sales of its equity accounted investments.

Performance

£22.0bn +3%
2008: £21.3bn

£22.4bn +21%
2008: £18.5bn

Comment

The year's intake¹ includes the Typhoon Tranche 3A production order, support orders totalling over £3bn for Typhoon, Harrier, Type 45, Spearfish and Sting Ray torpedoes, and the three-year Saudi Typhoon availability service contract. Prior year intake benefited from the peak of demand for armoured wheeled vehicles in the US and awards for the 15-year UK munitions capability contract.

The increase in sales¹ this year has primarily been driven by increased deliveries of Typhoon Tranche 2 standard aircraft, initial deliveries of Typhoon aircraft and support to the Kingdom of Saudi Arabia, and a 6% underlying growth in the Electronics, Intelligence & Support operating group.

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 the Financial review on page 30)

3 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)

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

UNDERLYING EBITA² (£M)

Underlying EBITA² is used by the Group for internal performance analysis as a measure of operating profitability that is comparable over time. 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 and, in 2009, an accounting gain as a result of pension benefit restructuring in the US, and regulatory penalties levied by the US Department of Justice and the UK's Serious Fraud Office.

£2,220m +17%
2008: £1,897m

UNDERLYING EARNINGS³ PER SHARE (PENCE)

Underlying earnings³ represent profit for the year attributable to equity shareholders from continuing operations 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 Earnings per Share (EPS) provides a measure of shareholder return that is comparable over time.

40.7p +10%
2008: 37.1p

OPERATING BUSINESS CASH FLOW⁴ (£M)

Operating business cash flow⁴ represents net cash flow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust.

£1,595m –%
2008: £1,595m

Excluding favourable exchange translation, the improved 2009 sales performance generated an increase in underlying EBITA².

Underlying EPS, excluding favourable exchange translation, is marginally lower reflecting higher underlying EBITA², more than offset by a higher underlying interest charge due to the cash cost of acquisitions made in 2008 and the lower level of interest received on the Group's cash holdings, and an increase in the Group's effective tax rate to 28%.

The 2009 operating business cash flow⁴ includes the expected utilisation of contract advances in the Programmes & Support operating group, and incremental deficit funding in respect of the UK and US pension schemes.

Links to further information

Further explanation of these Group financial KPIs for the years ended 31 December 2009 and 2008 are included within the Financial review on pages 30 to 37.

Individual operating group financial KPIs are included within the Operating group reviews on pages 56 to 73, and a reconciliation to the Group KPIs is presented on page 55.

Executive directors' remuneration is linked to Earnings per Share and cash flow performance. Further information is given within the Remuneration report on pages 96 to 98.

Programme Execution and Customer Focus

Programme Execution and Customer Focus are at the core of the successful delivery of the Group's Total Performance strategy

Link to 2009 Executive Committee top ten objectives

1 Meet 2009 financial targets, 2 Further enhance programme execution through schedule and cost performance

p7

FOR MORE INFORMATION ON OUR
2009 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

	PROGRAMME MARGIN VARIATION	SCHEDULE ADHERENCE	CUSTOMER SATISFACTION
Description	Programme margin variation measures outturn projections of and movements in margin of key customer-funded projects. It provides an indicator of our ability to effectively manage major programmes.	Schedule adherence measures the timing of achievement of key milestones. It shows how well we are performing against key contract commitments.	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.
Performance	The Group targets an aggregated year-on-year improvement in programme margin across its major contracts. This targeted improvement was achieved.	The Group targets an aggregated improvement in schedule adherence metrics relating to milestones across its major contracts. This targeted improvement was achieved.	The Group targets an aggregated year-on-year improvement in customer satisfaction across its major contracts. This targeted improvement was not achieved.
Comment	The contract management metrics are consistently used by the Board to provide oversight of programme performance. These metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.	The contract management metrics are consistently used by the Board to provide oversight of programme performance. These metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.	Plans to improve the performance on those contracts reporting a deterioration in customer satisfaction are being implemented on a contract-by-contract basis.
Links to further information	Programme margin variation, schedule adherence and customer satisfaction are regularly reviewed under Lifecycle Management (LCM), which is a mandated core business process under the Operational Framework. It provides a structured approach to managing contractual commitments and investments throughout project and product lifecycles. Further information on LCM is given on pages 15 and 84.		

Mandated policies and processes

The Group's policies and processes provide a stable foundation from which to deliver the strategy

Link to 2009 Executive Committee top ten objectives

10 Ensure continued application of business policies and processes

p7 FOR MORE INFORMATION ON OUR 2009 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

Responsible Behaviour

High standards of corporate responsibility are essential to the Group's mission to deliver sustainable growth

Link to 2009 Executive Committee top ten objectives

3 Progress towards a recognised leadership position on the Corporate Responsibility agenda, 4 Drive safety performance to a level comparable with leading performers

p7 FOR MORE INFORMATION ON OUR 2009 EXECUTIVE COMMITTEE TOP TEN OBJECTIVES

OPERATIONAL ASSURANCE STATEMENT (OAS)

The OAS requires that each part of the business completes a formal review of its compliance against the Operational Framework, including operational and financial controls, and risk management processes, every six months

The level of application of mandated policies is assessed against defined scoring criteria. Where scores are below the minimum standard, action plans to achieve the minimum standard are implemented

GLOBAL CODE OF CONDUCT

The global Code of Conduct was launched in January 2009. It defines the principles and standards of responsible business conduct we expect of employees wherever they work globally. During the year, the Code was communicated to employees through team briefings. Employees received online or classroom-based training on the Code and were also asked to acknowledge that they understood and would comply with its requirements.

SAFETY

The number of incidents resulting in days lost to injuries is monitored and actions taken to minimise the risk to our employees and our operations, and drive continual performance improvement. In previous reports, days lost to work-related injuries was used as the Group's key safety metric. From 2009, this has been replaced by the lost work day case rate, which focuses on the causes of accidents and enables a more meaningful comparison with other companies.

21%

Improvement

The Group targeted an improvement of 20% in scores below the minimum standard during 2009. The actual improvement in scores during 2009 was 21%. Newly acquired businesses are targeted to reach the minimum standard in 75% of mandated policies within 12 months of acquisition. Overall, the Tenix Defence, Detica and ex-VT Group businesses acquired during 2008 achieved the minimum standard in 76% of the Group's mandated policies against the 75% target in 2009.

With effect from 1 January 2010, new and updated mandated policies have been introduced as part of the implementation of the Woolf Committee recommendations. The businesses are required to develop plans to implement these policies, and they will be measured by the achievement of milestones towards full implementation.

There was no Executive Committee target in 2009 in respect of Performance Centred Leadership (PCL) and, therefore, a PCL KPI has not been presented this year.

OAS is a mandated policy under the Operational Framework. Further information on the Operational Framework is given in the Corporate governance section on page 81.

95%

Briefed and trained¹

The Group's target was to brief and train 100% of employees¹ in position before 31 October on the Code during 2009.

The briefing and training achievement of 95% includes our Surface Ships business (approximately 7,000 employees) which joined the Group on 30 October 2009. The Executive Committee considers its target to have been substantively met and actively continues to ensure that the remaining employees complete the Code of Conduct programme.

86%

Acknowledged¹

A new KPI in respect of the global Code of Conduct has been presented this year. These metrics are used to measure the Executive Committee's success in progressing the Group towards becoming a recognised leader in responsible business conduct.

Further information on the Group's performance is given within the Corporate Responsibility review on pages 38 to 45. Executive directors' remuneration is also linked to certain of these measures of performance on business conduct and safety. Further information is given within the Remuneration report on pages 96 to 98.

¹ Wholly-owned subsidiaries only, excluding employees on long-term absence

FINANCIAL REVIEW

“Another year of good underlying growth.”

- The £46.9bn (2008 £46.5bn) order book¹ continues to provide excellent forward visibility
- £261m accounting gain on US pension restructuring and £278m of regulatory penalties excluded from underlying EBITA²
- Underlying EBITA² has increased by 17% to £2,220m (2008 £1,897m)
- £973m of impairment charges largely relating to the ex-Armor Holdings business
- Underlying earnings³ per share has increased by 10% to 40.7p per share (2008 37.1p)
- The total dividend has increased by 10% to 16.0p per share (2008 14.5p)

George Rose Group Finance Director

Summary income statement

	2009 £m	2008 £m
Sales¹	22,415	18,543
Underlying EBITA²	2,220	1,897
Return on sales	9.9%	10.2%
Profit on disposal of businesses	68	238
Pension accounting gain	261	–
Regulatory penalties	(278)	–
EBITA	2,271	2,135
Amortisation of intangible assets	(286)	(247)
Impairment of intangible assets	(973)	(177)
Net financial (expense)/income ¹	(707)	697
Taxation expense ¹	(350)	(640)
(Loss)/profit for the year	(45)	1,768

Exchange rates

£/\$ – average	1.566	1.853
£/€ – average	1.123	1.258

ORDER BOOK¹

Order book¹ increased to £46.9bn (2008 £46.5bn) largely reflecting the acquisition of VT Group's 45% interest in the BVT Surface Fleet (BVT) joint venture (£2.1bn). Excluding the impact of exchange translation, the order book is broadly unchanged year-on-year.

INCOME STATEMENT

Sales¹ increased by 21% to £22.4bn (2008 £18.5bn). Like-for-like growth, after adjusting for the impact of exchange translation, and acquisitions and disposals, was 7%. Despite the planned lower level of land vehicle sales in the US, growth was delivered through increased deliveries of Typhoon Tranche 2 standard aircraft to the European partner nations, initial deliveries of Typhoon aircraft and support to the Kingdom of Saudi Arabia, and a 6% underlying growth in the Electronics, Intelligence & Support operating group. US-led businesses were responsible for 55% (2008 59%) of sales¹. 91% of sales¹ were generated from home markets (2008 88%). The Group's sales¹ performance is illustrated in the bridge chart below.

Underlying EBITA Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as Underlying EBITA. In order to ensure that it continues to provide a measure of profitability that is comparable over time, it has been amended to exclude all non-recurring items. Underlying EBITA continues to be the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 3 to the Group accounts on a segmental basis.

Underlying EBITA² increased by 17% to £2,220m (2008 £1,897m). This includes favourable exchange translation of £187m. Return on sales reduced to 9.9% after expensing of the Mine Resistant Ambush Protected (MRAP) All-Terrain Vehicles (ATV) research and development,

and bid costs (£56m) in the US businesses, and for trading initial deliveries of Typhoon to the Kingdom of Saudi Arabia at lower margins reflecting the early stage of that contract. US-led businesses delivered 53% (2008 57%) of the Group's underlying EBITA². The increase in underlying EBITA² 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, nature and function. The non-recurring items for the current and prior years are as follows:

Profit on disposal of businesses 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 prior year profit of £238m included the accounting gain on the disposal of the Group's interests in the businesses contributed to BVT (£121m), and profit on disposals of the Surveillance & Attack business (£61m) and the Group's interest in Flagship Training (£56m).

The **pension accounting gain** of £261m in 2009 has resulted from pension benefit restructuring in the US. It has been excluded from underlying EBITA² on the basis of its materiality and non-recurring nature.

The **regulatory penalties** of £278m in 2009 reflect the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3. These have been excluded from underlying EBITA² on the basis of their materiality and non-recurring nature.

Amortisation of intangible assets is £39m higher at £286m mainly for the impact of a full year of charges in respect of the businesses acquired in 2008.

ORDER BOOK¹ (£BN)

£46.9bn
2008 £46.5bn

SALES¹ (£BN)

£22.4bn
2008 £18.5bn

UNDERLYING EBITA² (£M)

£2,220m
2008 £1,897m

(KPI)

(KPI)

SALES¹ BRIDGE (£BN)

UNDERLYING EBITA² BRIDGE (£M)

- 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
- 3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives and non-recurring items

Impairment of intangible assets of £973m primarily relates to the goodwill and intangible assets acquired with Armor Holdings in 2007. The impairment largely reflects the non-award of the follow-on Family of Medium Tactical Vehicles production contract (£592m) and the weaker outlook for the US-based Products Group business (£264m). In addition, £34m has been taken relating to the discontinued financial services element of the Detica business. The prior year charge of £177m included a reduction in the market value of the Group's interest in Saab of Sweden (£120m) and a charge against the Products Group (£40m). Further disclosure is provided in note 11 to the Group accounts.

Net financial expense¹ was £707m (2008 net financial income £697m). The underlying net interest charge increased to £195m (2008 £102m) primarily on the cash cost of business acquisitions made in 2008, lower interest received on cash held and the carrying cost of \$1.5bn US bonds issued in June 2009. A net expense of £512m (2008 net credit £799m) arose from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements, reversing much of the net income recorded in 2008 from these items.

Taxation expense¹ reflects an effective tax rate of 28% (2008 26%), which is expected to increase to 29% in 2010. The effective tax rate is based on profit before taxation excluding goodwill impairment of £725m and regulatory penalties (£278m).

EARNINGS PER SHARE

Basic loss per share, in accordance with IAS 33, *Earnings per Share*, was 1.9p (2008 earnings 49.6p). The reduction on 2008 mainly reflects the impairments, regulatory penalties, and reversal of gains made in 2008 on marked-to-market revaluation of financial instruments and foreign currency movements.

Underlying earnings³ per share was 40.7p (2008 37.1p), an increase of 10%. The increase in underlying earnings³ per share is illustrated in the bridge chart below.

Reconciliation from underlying EBITA² to underlying earnings³

	2009 £m	2008 £m
Underlying EBITA²	2,220	1,897
Net financial expense excluding non-cash finance movements on pensions and financial derivatives (see note 6 to the Group accounts)	(195)	(102)
	2,025	1,795
Taxation	(567)	(467)
Minority interests	(22)	(23)
Underlying earnings³	1,436	1,305
Weighted average number of shares	3,532m	3,519m
Underlying earnings³ per share	40.7p	37.1p

DIVIDENDS

The Board is recommending a final dividend of 9.6p per share (2008 8.7p), bringing the total dividend for the year to 16.0p per share (2008 14.5p), an increase of 10%.

The proposed dividend is covered 2.5 times by underlying earnings³ (2008 2.6 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 EARNINGS³ PER SHARE
(PENCE)

40.7p
2008: 37.1p



UNDERLYING EARNINGS³ PER SHARE BRIDGE
(PENCE)

DIVIDEND
(PENCE PER SHARE)

16.0p
2008: 14.5p

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

3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items

4 See note 27 to the Group accounts

BALANCE SHEET

Summary balance sheet

	2009 £m	2008 £m
Intangible assets	11,253	12,306
Property, plant and equipment, and investment property	2,663	2,558
Equity accounted investments and other investments	852	1,040
Other financial assets and liabilities (net)	(45)	240
Tax assets and liabilities (net)	850	256
Pension deficit as defined by the Group	(4,410)	(3,325)
Working capital	(6,839)	(5,825)
Net cash as defined by the Group ⁴	403	39
Net assets	4,727	7,289

Exchange rates

£/\$ – year end	1.615	1.451
£/€ – year end	1.125	1.042

Exchange translation, principally in respect of the Group's US-dollar denominated businesses, reduced net assets by £302m

The £1.0bn reduction in **intangible assets** to £11.3bn (2008 £12.3bn) mainly reflects amortisation and impairment (£1.3bn), and adverse exchange translation (£0.7bn), partly offset by the goodwill and intangible assets recognised on the acquisition of VT Group's 45% interest in BVT (£0.8bn)

The reduction in **equity accounted investments and other investments** from £1,040m to £852m is largely due to the acquisition of VT Group's 45% interest in BVT in October 2009. BVT, now re-named BAE Systems Surface Ships, is a wholly-owned subsidiary of the Group and its balance sheet, and associated purchased goodwill, are now consolidated on a line-by-line basis

The movement in **retirement benefit obligations** during the year is shown below and further disclosure is provided in note 21 to the Group accounts

	£m
Deficit in defined benefit pension plans at 1 January 2009	(4,155)
Increase in liabilities due to changes in assumptions	(3,342)
Actual return on assets above expected returns	1,258
Contributions over service cost	475
Non-recurring accounting gain	261
Exchange translation	96
Other movements	(166)
Deficit in defined benefit pension plans at 31 December 2009	(5,573)
US healthcare plans	(43)
Total IAS 19 deficit	(5,616)
Allocated to equity accounted investments and other participating employers	979
Group's share of IAS 19 deficit at 31 December 2009	(4,637)
Assets held in Trust	227
Pension deficit as defined by the Group	(4,410)

The better than expected investment returns and the restructuring of the US pension schemes has been outweighed by a reduction in real discount rates resulting in the Group's share of the pension deficit increasing to £4,637m from £3,325m at 31 December 2008. The real UK discount rate of 2.2% at the end of 2009 compares with an historic ten year average of 2.9% (see table and chart below)

	2009	2008
Discount rate	5.7%	6.3%
Inflation	3.5%	2.9%
Real discount rate	2.2%	3.4%

During the year, the Group contributed £225m into Trust for the benefit of the Group's main pension scheme. This contribution is reported within other investments – current (£211m including a fair value gain of £2m), and cash and cash equivalents (£16m) in the consolidated balance sheet at 31 December 2009. The use of these assets is restricted under the terms of the Trust. The Group considers the contribution to be equivalent to the other one-off contributions it makes into the Group's pension schemes and, accordingly, presents a definition of the pension deficit above to include this contribution.

A net deferred tax asset of £1,430m (2008 £1,115m) relating to the Group's pension deficit is included within net tax assets and liabilities, and disclosed in note 8 to the Group accounts

UK DISCOUNT RATE AND INFLATION OVER THE TEN YEARS TO 31 DECEMBER 2009

CASH FLOW

Reconciliation of cash inflow from operating activities to net cash

	2009 £m	2008 £m
Cash inflow from operating activities	2,232	2,009
Capital expenditure (net) and financial investment	(489)	(503)
Dividends received from equity accounted investments	77	89
Assets contributed to Trust	(225)	–
Operating business cash flow⁵	1,595	1,595
Interest	(186)	(98)
Taxation	(350)	(261)
Free cash flow	1,059	1,236
Acquisitions and disposals	(253)	(1,001)
Debt acquired on acquisition of subsidiary	(1)	(37)
Purchase of equity shares (net)	(20)	(27)
Equity dividends paid	(534)	(478)
Dividends paid to minority interests	(5)	(11)
Cash inflow/(outflow) from matured derivative financial instruments	36	(440)
Movement in cash collateral	(11)	106
Movement in cash received on customers' account ⁶	(12)	26
Foreign exchange	262	(374)
Other non-cash movements	(157)	339
Movement in net cash as defined by the Group	364	(661)
Opening net cash as defined by the Group ⁴	39	700
Closing net cash as defined by the Group⁴	403	39

Components of net cash as defined by the Group⁴

	2009 £m	2008 £m
Debt-related derivative financial assets	39	203
Other investments – current	211	–
Cash and cash equivalents	3,693	2,624
Loans – non-current	(2,840)	(2,608)
Loans and overdrafts – current	(453)	(173)
Cash received on customers' account ⁶	(20)	(7)
Assets held in Trust	(227)	–
Closing net cash as defined by the Group⁴	403	39

Cash inflow from operating activities was £2,232m (2008 £2,009m), which includes contributions in excess of service costs for the UK and US pension schemes totalling £475m (2008 £321m)

There was an outflow from **net capital expenditure and financial investment** of £489m (2008 £503m), which included £94m (2008 £183m) in respect of new residential and office facilities in Saudi Arabia

Dividends received from equity accounted investments, primarily MBDA, Saab and Eurofighter, totalled £77m (2008 £89m)

Assets contributed to Trust comprises the £225m of payments made into Trust during the year for the benefit of the Group's main pension scheme. As the use of these assets is restricted under the terms of the Trust, they are excluded from the Group's definition of net cash. Consistent with the presentation of other one-off contributions into the Group's pension schemes, the contribution is presented within operating business cash flow

Interest increased to £186m (2008 £98m) largely reflecting the cash cost of business acquisitions in 2008, lower interest received on the Group's cash holdings and the carrying cost of the \$1.5bn US bonds issued in June 2009

Taxation payments increased to £350m (2008 £261m) mainly as a result of the higher taxable profits generated by the Group in 2008

Net cash outflow in respect of **acquisitions and disposals** was £253m. This mainly comprises net payments made to acquire VT Group's 45% interest in BVT, including acquired cash (£315m), and Advanced Ceramics Research, Inc. (£9m), less the deferred consideration received relating to the 2008 disposal of a 50% interest in Flagship Training (£70m). In the prior year, the Group acquired MTC, Tenix Defence and Detica, and disposed of the Surveillance & Attack business and interest in Flagship Training for net cash consideration of £1bn

The Group finances part of its investment in its US businesses through an intercompany loan. As at 31 December 2009, \$2.1bn (2008 \$2.1bn) of a total of \$3.6bn (2008 \$6.6bn) was hedged using a rolling programme of short-term foreign exchange hedges. As a consequence of the weakening of the US dollar, there has been a **cash inflow from matured derivative financial instruments** of £36m (2008 outflow £440m) from rolling these hedges into 2010

Foreign exchange translation during the year, primarily in respect of the Group's US dollar-denominated borrowing, increased reported cash by £262m

⁴ See note 27 to the Group accounts

⁵ See note 26 to the Group accounts

⁶ 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.

CAPITAL

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

At 31 December 2009, the Group's capital was £4,614m (2008 £6,893m), which comprises total equity of £4,727m (2008 £7,289m) less amounts accumulated in equity relating to cash flow hedges of £113m (2008 £396m). Net cash as defined by the Group was £403m (2008 £39m).

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

In 2010, the Group will initiate a programme to return up to £500m to shareholders by way of a market purchase of shares. This programme is set in the context of an appropriately balanced use of capital. In addition to this accelerated return to shareholders, the Group will continue to pursue its strategy of organic investment and investing in attractive sectors of the defence market through selective acquisitions.

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 taxation expertise.

The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the framework of treasury policies and guidelines approved by the Board. 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'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.

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

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 as follows:

	2009 £m	2008 £m
Less than one year	441	173
Between one and five years	1,427	1,557
More than five years	1,386	848
Loans and overdrafts – current and non-current ⁷	3,254	2,578

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.

In June 2009, the Group raised \$1.5bn in the US bond market in order to finance debt maturities in 2010 and 2011. The financing was accomplished through the issue of two tranches of notes, \$500m due in June 2014 with a coupon of 4.95% and \$1bn due in June 2019 with a coupon of 6.375%. The net incremental interest cost of this additional debt funding was £23m during 2009.

A \$500m 4.75% bond is due to be repaid in August 2010.

Generally, excluding the impact of acquisition or disposal financing, net cash/debt as defined by the Group⁴ 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 pro-active in accessing the 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.

The Group's current interest rate management policy is that a minimum of 50% (2008 25%) and a maximum of 75% (2008 75%) of gross debt is maintained at fixed interest rates. At 31 December 2009, the Group had 62% (2008 73%) of fixed rate debt and 38% (2008 27%) of floating rate debt based on a gross debt of £3.3bn including debt-related derivative financial assets (2008 £2.6bn).

In 2009, \$1bn of the \$1.5bn debt issued in the year was converted to a floating rate bond by utilising a series of interest rate swaps.

MATURITY PROFILE OF THE GROUP'S BORROWINGS⁷ (£m)

⁷ Includes £39m (2008 £203m) of debt-related derivative financial assets presented within other financial assets in the Group's balance sheet.

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 has a committed Revolving Credit Facility (RCF) of £1.455bn (2008 £1.5bn), which is syndicated amongst the Group's core relationship banks and is available to meet expected general corporate funding requirements. A £45m commitment in the RCF from Lehman Brothers Commercial Paper Inc. was cancelled during 2009 following an all bank consent process. The RCF also provides standby funding for the Group's US Commercial Paper programme. The Group has not issued any Commercial Paper during 2009. The RCF is contracted until 2012, although the available amount for the final year reduces to £1.3bn. The RCF remained undrawn throughout the year.

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

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 purposes, all transactions are marked-to-market and the resultant exposure is allocated against the credit limit. The Group had cash and short-term investments at 31 December 2009 of £3,904m (2008 £2,624m), which was invested with 27 (2008 14) financial institutions. The maximum amount deposited with any individual bank as at 31 December 2009 was less than £300m (2008 £250m).

Currency

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 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.

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 and 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 2009, 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 2009, the Group 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.

Contract revenue and profit recognition

A significant proportion of the Group's defence activities are conducted under long term contract arrangements and are accounted for in accordance with IAS 11, *Construction Contracts*.

Revenue is recognised on such contracts 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, the 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 are expensed as incurred. Material changes in one or more of these estimates, whilst not anticipated, would affect the profitability of individual contracts.

Where goods are supplied under arrangements not considered to represent construction contracts, as defined by IAS 11, 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 concerning the Group's revenue recognition policy are in note 1 to the Group accounts.

Retirement benefit plans

The Group accounts for post-retirement pension and healthcare plans in accordance with 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 relate to the expected return on investments within the Group's plans, the rate of increase in pensionable salaries, the rate of increase in the retail price index, the mortality rate of plan members and the discount rate applied in discounting liabilities. For each of these assumptions there is a range of possible values and, in consultation with our 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 calculated under IAS 19.

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. These funding requirements are derived from separate independent actuarial valuations.

Additional details concerning the Group's retirement benefit plans are given in notes 1 and 21 to the Group accounts.

Intangible assets

In accordance with IFRS 3, *Business Combinations*, goodwill arising on acquisition of subsidiaries is capitalised and included in intangible assets. Goodwill on acquisition of joint ventures and associates is included in equity accounted investments. IFRS 3 also requires the identification of other acquired intangible assets. The techniques used to value these intangible assets are in line with internationally used models, but do require the use of estimates which may differ from actual outcomes. Future results are impacted by the amortisation period adopted for these items and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.

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 business. Additional details concerning the Group's treatment of intangible assets and impairment reviews are given in notes 1 and 11 to the Group accounts.

CORPORATE RESPONSIBILITY REVIEW

HOW WE REPORT

Corporate Responsibility is an integral part of BAE Systems' Total Performance approach. Total Performance is about every aspect of the way we do business: Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour.

To reflect this, we aim to increasingly integrate our reporting of Corporate Responsibility performance into the Annual Report and increase the amount of information available online.

Our separate Corporate Responsibility Report is independently assured by Deloitte LLP.

In this report:

- Summary of our 2009 Corporate Responsibility performance
- Update on our approach to responsible business conduct

In our separate Corporate Responsibility Report:

- Our Safety Maturity Matrix explained
- Update on our approach to environment
- www.baesystems.com/cr09/

On our website:

- Our support for local communities
- Safety stories from our business
- www.baesystems.com/corporateresponsibility/

Continuing to embed a high performance culture, including delivery of our Corporate Responsibility (CR) agenda, was one of our five Group Strategic Objectives in 2009. Responsible behaviour is now further embedded in our strategy as one of the four key elements of Total Performance.

Total Performance focuses not just on what we do but also how we do it. It is about every aspect of the way we do business: Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour.

OUR APPROACH

Responsible business conduct and safety continued to be our priorities for improving CR performance in 2009. These have been identified as the issues with the most potential to impact the Group's reputation and ability to operate. Achieving the highest standards in these areas will build trust and enhance our relationships with stakeholders. Objectives have been set to drive us towards leadership performance in both areas and encourage adoption of consistent standards across the Group.

Strong, visible leadership is essential to the delivery of our objectives. In 2009, an average of 12.3% of the potential annual incentive for Executive Committee members was allocated according to the Group's achievement of key performance objectives for responsible business conduct and safety.

Other important aspects of our CR agenda include diversity and inclusion, environmental sustainability, community involvement and education.

Governance of Corporate Responsibility

Key performance indicators on our CR priorities are reported to the Executive Committee on a quarterly basis and reviewed as part of our Quarterly Business Review process. CR is an integral part of our Operational Framework, and is subject to internal and external assurance processes.

The Managing Director Corporate Responsibility, Raj Rajagopal, supports line leaders in driving the CR agenda and reports directly to the Chief Executive. We established a global CR Forum in 2009 to support our operating groups in fulfilling the Group's CR agenda. The CR Forum helps to develop awareness and understanding of CR among our employees, and embed sustainable improvements across our range of CR focus areas.

Progress against CR objectives is reviewed quarterly by the CR Committee, chaired by non-executive director Andy Inglis. The Committee provides independent oversight, advice and strategic direction on social, ethical and environmental issues that face the Group. The Committee's report can be found on page 86.

Raj Rajagopal
Managing Director,
Corporate Responsibility

RESPONSIBLE BUSINESS CONDUCT

BAE Systems is committed to becoming a recognised leader in responsible business conduct. Our Total Performance approach aims to establish a clear understanding and shared commitment to responsible business conduct from all our employees.

The Woolf Committee – an external, independent committee appointed by the BAE Systems Board and chaired by Lord Woolf, former Lord Chief Justice of England and Wales – reported its findings in May 2008. The Group established a three-year programme in 2008 to implement the Committee's 23 recommendations on how BAE Systems could achieve a leadership position in responsible business conduct.

2009 performance

The 2009 milestones for the programme, which focused on reviewing and strengthening company processes and policies, and roll-out of the Code of Conduct, have all been substantively achieved. The Board Charter has been amended to include the Board's responsibilities for ensuring high standards of responsible business conduct across the Group. The remit of the CR Committee has been extended to include its responsibility for oversight and reporting against those standards. All relevant policies and processes have been agreed by the Executive Committee, and incorporated into the Group's central system of governance, the Operational Framework, at the beginning of January 2010.

Code of Conduct

The Code of Conduct, launched in January 2009, defines the principles and standards of responsible business conduct we expect of all employees. We intend that the Code will be reviewed regularly to ensure it continues to meet best practice, with the first review being conducted during 2010.

The Code of Conduct was communicated to employees in 2009 through team briefings. The briefings were designed to cover how the Code of Conduct applies to employees in their daily work lives, and aimed to create an environment where employees feel they can speak up, ask questions and raise any issues relating to responsible business conduct.

Employees were required to undertake either online or classroom-based training on the Code of Conduct (see case study above). Approximately 91,000 employees in our wholly-owned businesses were briefed and trained in 2009, representing approximately 95% of the workforce¹.

These employees were also asked to formally acknowledge that they understood and would comply with the Code's requirements. By the end of 2009, approximately 86% of the workforce¹ had provided their written acknowledgement.

Activity continues to ensure that the remaining employees complete the Code of Conduct programme. Refresher training will begin in 2010. We have also updated our policy to ensure that breaches of the Code of Conduct are subject to disciplinary procedures.

The Group is not in a position to require our non-controlled joint ventures or suppliers to adopt our specific standards (including operating an Ethics Helpline) in their business activity. However, it is our aim that there is clear understanding and a shared set of values governing how we do business with our joint ventures.

Know the Code

Our objective in 2009 was to ensure that our employees are aware of the Code of Conduct and understand how it applies to their day-to-day working lives. During 2009, we trained approximately 91,000 employees working in a wide range of roles in many countries around the world using a range of training materials.

As an example, our Military Air Solutions business in the UK used mobile IT training facilities to enable manufacturing employees without access to computers to take the online course in their normal place of work. Where appropriate, employees were trained through classroom sessions, during which they were encouraged to take part in interactive case studies.

Many employees took our online course, which explains the key aspects of the Code of Conduct. The course guides staff through a series of animated scenarios where employees are faced with typical ethical dilemmas and includes a test to confirm understanding of the Code.

In 2010, we plan to provide our top 1,000 suppliers with a copy of our Code of Conduct and they will be encouraged to work to equivalent standards.

Governance

We have reviewed Group policies and governance processes in certain areas in keeping with the Woolf Report recommendations. This includes the development of a set of Responsible Trading Principles (see page 5).

Our new and revised policies, including our Product Trading and Pursuit of Export Opportunities policies, require us to make informed assessments and decisions about the nature of our products and the business opportunities we pursue. Products must be assessed against four criteria: the type of product, its intended use, the end user and, for exports, the country of sale.

The revised policy on offset (agreements with export customers to generate work or create capability in their countries) requires us to ensure that robust procedures are in place for assessing and committing to such agreements.

In the settlement reached with the US Department of Justice in February 2010 in connection with its investigation commenced in 2007, the Company made commitments to the Department of Justice concerning the Group's ongoing regulatory compliance, including the appointment of an independent corporate monitor for a period of up to three years to monitor the Company's compliance with such commitments.

¹ As at 31 December 2009 – wholly-owned subsidiaries only, excluding employees on long-term absence.

CORPORATE RESPONSIBILITY OBJECTIVES

	BUSINESS CONDUCT	SAFETY	DIVERSITY AND INCLUSION
2009 objectives	– Senior leadership each to lead two employee focus/engagement sessions to discuss the global Code of Conduct and ethical issues – Deliver the 2009 Woolf Committee implementation plan milestones and obtain independent external assurance of this – Employee sample survey on selected ethics questions to be carried out in the fourth quarter of 2009. Results to show an improvement relative to the 2008 survey results	– Senior leaders each to undertake three safety audits, and flow-down training and requirement to conduct safety reviews to two levels below the Executive Committee – Minimum of Level 3 on the Safety Maturity Matrix (SMM), with 60% of sites progressed to Level 4 by the end of 2009 – Incident rate targets to be set by business at a level reflecting the progress required to achieve the 2011 target of best in class – Incident rate in 2009 to show at least a 10% improvement over 2008 and, for sites with significantly worse than best in class statistics, improvement targets to be set consistent with achieving best in class in 2011	– Senior leadership to participate in a workshop to develop the inclusion agenda for their business. Senior leaders to lead two events with employee groups to develop action plans to address culture, barriers and improvements – Executive Committee to review the Operational Framework and supporting policies and processes to identify potential improvements required to develop a more inclusive culture. Any changes to be included in the updated July 2009 version of the Operational Framework – Senior leadership to develop one personal objective on inclusion during the first half of 2009 for implementation in the second half of the year
Progress	– The Code of Conduct was communicated to employees in 2009 through team briefings – The 2009 milestones for the Woolf implementation programme have been substantively achieved. These covered approval by the Executive Committee and the Board of proposed solutions in response to the Woolf Report's 23 recommendations, and the launch and roll-out of the global Code of Conduct – In late 2009, a sample of approximately 10% of employees worldwide were invited to participate in a survey on the Group's approach to responsible business conduct (see page 41 for results)	– In 2009, safety audits were largely completed as planned and, in addition, many of our lines of business also required other managers (below senior leader level) to participate in audits to enhance their safety knowledge – Our operating groups confirmed that the minimum standard of safety across their lines of business met Level 3 requirements on the SMM. Over 60% of major manufacturing sites achieved Level 4 – All of our operating groups have set targets to reduce the rate of safety incidents in line with achieving best in class performance by the end of 2011 – The total incident rate fell by 33% against the 10% improvement target to 562 recorded injuries per 100,000 employees	– During 2009, we held a number of workshops attended by senior management and functional groups to develop our inclusion agenda – The Operational Framework was reviewed to ensure it reflects the Group's commitment to inclusion, and ensure it encourages the behaviours and culture needed to underpin the Code of Conduct – Senior leadership each committed to a personal inclusion objective. These included objectives relating to mentoring, supporting women's network events and leading focus groups with minority employee groups
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. 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	Continue the progress towards a world class level of safety performance – All businesses and BAE Systems-controlled sites of over 150 personnel to attain Level 4 of the 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 Days incident rate compared with 2009	Develop a global working climate which embraces diversity and inclusion – Create a plan to deploy the Diversity and Inclusion Maturity Matrix by the end of the first quarter and meet the 2010 milestones towards desired end state to be achieved by the end of 2015

In 2007, we created a Business Development Adviser Compliance Panel (the 'Panel') for the review and assessment of adviser appointments including for business development, security and offset advisers. All appointments of lobbyists are required to be reviewed by the Panel, other than certain domestic US appointments which are subject to separate legislative controls. The Panel, which is required to advise the Company as to whether it should proceed with an adviser appointment, is chaired by independent third parties who are partners from leading law firms. Our revised process for the appointment, selection and management of advisers was described by the Woolf Committee as leading-edge practice. All advisers added to the Company's adviser register in 2009 were appointed in accordance with a new global adviser policy introduced from 1 January 2009, with the exception of a limited number of US advisers who were already being assessed before the introduction of the new global adviser policy. However, this limited group of US advisers were also assessed by the Panel which recommended their appointment.

In accordance with the settlement reached with the US Department of Justice referred to above, the independent corporate monitor shall serve as an ex-officio non-voting member of the Panel and the mandate of the Panel shall be expanded to include review of certain other matters relating to international business development.

Our policy on lobbying governments and other bodies has been revised to require all those lobbying externally on BAE Systems' behalf to comply with our Code of Conduct. From 2010, a report on lobbying activities must also be provided to the CR Committee.

An updated Gifts and Hospitality Policy sets out clear requirements for employees, including limits on the giving and receiving of gifts and hospitality, together with recording of these activities. We have also amended our Company Giving Policy to give clear guidance on all Company donations.

Our Facilitation Payments Policy states that employees are prohibited from making facilitation payments irrespective of whether or not they are permitted by local laws, and requires employees to decline and report any request for such payment.

Working to improve industry standards

BAE Systems is a member of both the Aerospace Industries Association of America and the Aerospace and Defence Industries Association of Europe, which agreed common Global Principles of Business Ethics for the Aerospace and Defence Industry in October 2009.

We are actively working with the UK defence industry to promote the adoption of responsible business practices and we welcome the publication of a draft Bribery Bill. The Bill aims to provide a comprehensive scheme to deter bribery offences enabling courts and prosecutors to respond more effectively to bribery in the public and private sectors within the UK or abroad.

BAE Systems, together with other leading multinationals, is supporting a new Centre for Law and Ethics at University College London. The Centre, established in October 2009, aims to promote debate on business ethics and help companies promote an ethical corporate culture.

Employee engagement

In late 2009, a representative sample (approximately 10%) of employees worldwide were invited to participate in a survey on the Group's approach to responsible business conduct. The survey covered the six questions related to responsible business conduct included in our biennial full employee opinion survey, which will next be held in 2010.

Overall, 41% of the sample responded. The results confirm that almost all respondents were aware of the ethical standards expected of them, with 75% of respondents believing that the Group demonstrates clear ethical standards (see table below).

Whilst these results are generally positive, there remain areas for us to focus on and improve.

Responsible business conduct survey results

Question	2008 full survey	2009 sample survey	Change from 2008 score
I have confidence that if I raised an ethical issue at work it would be addressed	67%	73%	+6%
I believe I could report instances of dishonest or unethical practices without fear of reprisal	63%	70%	+7%
The culture of BAE Systems is one where employees are treated with fairness and respect	62%	71%	+9%
I believe BAE Systems demonstrates clear ethical standards	73%	75%	+2%
I think it is safe to speak up and challenge the way things are done in BAE Systems	54%	57%	+3%
I am aware of the ethical standards that the Company expects of me	94%	97%	+3%

Ethics Helpline

Employees made 870 enquiries to our Ethics Helpline in 2009 to request information and advice or raise concerns confidentially about business conduct. Procedures are in place to ensure ethical concerns are investigated and the findings are reported to the Ethics Review Committee or, for BAE Systems, Inc., to the Ethics Executive Oversight Committee.

ETHICS ENQUIRIES FROM EMPLOYEES

Focus on safety at US shipyards

Ship Repair sites in the US are developing a safety programme aimed at creating an accident free workplace and to embed a safety culture among employees. Compulsory safety training has been introduced for all employees and managers. Safety performance is included in the personal development review process for managers. Regular employee safety surveys are used to help managers understand attitudes to safety and identify areas for improvement. Three of the four Ship Repair sites achieved Level 4 on the Safety Maturity Matrix in 2009 and safety performance has improved significantly.

Ship Repair's lost work day case rate demonstrated a 57% improvement compared with 2008.

SAFETY

The safety of employees and those using our products is critical to our business and an important responsibility. Our goal is to ensure consistently good safety management across the Group in the short term and to drive performance to a level comparable with the best performing global companies by the end of 2011.

In 2008, we put in place a four-year safety plan outlining the steps required to move towards leadership in safety performance. Ensuring a common understanding of our safety goals is a priority, particularly given the diverse nature of our businesses, the different regulatory environments we operate in and the range of safety risks we must manage.

A five-level Safety Maturity Matrix (SMM) is used to drive continual improvement and to monitor progress across the Group. By 2011, our target is for all our manufacturing sites to achieve Level 5 (best in class). A Senior Safety Steering Group has been established comprising senior safety leaders from each operating group, the Head of Safety Assurance and the Deputy Managing Director Corporate Responsibility.

2009 performance

Each line of business met SMM Level 3 requirements. This means that they have in place systems aligned with occupational health and safety standard OHSAS 18001 to address the majority of safety issues, that they have a safety risk register, and that there is systematic training for most employees in safety roles. Over 60% of major manufacturing sites achieved Level 4, making the step-change to a proactive and integrated approach to safety management across their operations. Internal audit, in conjunction with senior safety managers, confirmed such achievement of Level 4 through audits at 30 major manufacturing sites globally.

In 2009, we reduced the total incident rate by 33% against the 10% improvement target to 562 recorded injuries per 100,000 employees.

All our operating groups are setting targets to reduce the rate of safety incidents in line with achieving best in class performance by the end of 2011.

In previous reports, we have used days lost to work-related injuries per 100,000 employees as our key safety metric. This year, we have moved to reporting the lost work day case rate per 100,000 employees (referenced as the incident rate within the safety objectives) to focus on the causes of accidents and enable more meaningful comparison with other companies.

The main causes of major injury in 2009 across the Group continue to be slips, trips and falls on the same level, accounting for 44% of recorded major injuries. Other causes of major injury include falls from height (18%), struck by moving (including flying/falling) object (13%) and injured while handling, lifting or carrying (8%). Root cause analysis of types of incidents will be carried out to identify common global issues and solutions.

We are deeply saddened to report the death of one of our employees during deployment of communications equipment in Australia. We are reviewing the cause of this accident and co-operating fully with the regulatory investigation.

Product Safety Review following Haddon-Cave Report

Following the publication of the independent report by Charles Haddon-Cave QC into the loss of Nimrod XV230 over Afghanistan in 2006, BAE Systems has appointed Dr Chris Elliott FREng, a leading systems engineer and barrister, to support and advise Nigel Whitehead FREng, Group Managing Director, Programmes & Support, to undertake a review of the Group's approach to product safety in the UK.

The review will examine current policies, processes, governance, actions and behaviours associated with product safety and will be conducted by a senior team of six people, with relevant qualifications and experience. The team will work to help develop and enhance the Group's approach to product safety and, where appropriate, understand how other industries have addressed comparable matters.

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

ENVIRONMENT

Reducing our impact on the environment and assisting suppliers to do the same, helps us to improve operational efficiency, reduce costs, and ensure compliance with legal and regulatory requirements. Product environmental performance is also of increasing interest to our customers.

Our global Environmental Policy states our commitment to reducing our impact on the environment and minimising the through-life impacts of our products. This is also included in our Code of Conduct.

2009 performance

During 2009, our primary focus at a global level was on energy use. We continued to monitor and report our energy use and business travel on a Group-wide basis.

For the third year running, we have commissioned the Coefficient Company to calculate our 2009 global carbon footprint and to help improve our data collection methods. This analysis is scheduled to be completed by the end of June 2010.

The Coefficient Company produced and provided an analysis of our 2008 global carbon footprint. Our carbon footprint has increased since 2007 for two principal reasons. Firstly, we have improved the coverage and accuracy of our energy and business travel data across the Group. Improvements in data have been supported by our work towards preparing for the UK Carbon Reduction Commitment and the Australian National Greenhouse & Energy Reporting Scheme. Secondly, new businesses acquired during 2008 have brought with them associated emissions, increasing our overall footprint.

Fluctuations in our use of water, waste and volatile organic compounds are heavily influenced by programme status. We continue to monitor and manage this data at site and facility level, but no longer aggregate it at a Group level.

Efforts to reduce energy use in our businesses this year included a new £1m partnership with the University of Central Lancashire to develop intelligent energy management systems.

In the UK, an environmental sustainability framework was piloted to help businesses plan for medium- and long-term risks and opportunities associated with issues such as climate change, materials scarcity and rising energy prices. The framework covers operational and product impacts, and our supply chain, and will be rolled out across the Group.

Product stewardship

Product environment working groups in the UK and US focus on assisting the lines of business in complying with environmental legislation and transferring best practice across the Group. A product environment management handbook and e-learning course were launched in 2009, and these are supported by a Group-wide intranet site.

Wind farm technology

BAE Systems has developed a systematic approach that helps wind farm developers address the impact wind turbines have on radar. The approach includes potential solutions ranging from modifications to radar electronics to careful positioning of wind farms and radars, and was awarded a commendation for innovation at the 2009 British Renewable Energy Association Awards.

Supply chain

Suppliers are expected to meet product safety and environmental standards. BAE Systems is a signatory to the UK Ministry of Defence's (MoD) Sustainable Procurement Charter and has committed to improve standards in the defence supply chain by educating suppliers, establishing performance measures and sharing best practice.

Our Sustainable Procurement Working Group has published guidance to help employees carry out supplier sustainability risk and impact assessments. These cover supplier performance on health and safety, environment and business conduct, as well as employee awareness and stakeholder dialogue. Assessments will be carried out as part of our supplier management process from 2010. Sustainability training is being developed in partnership with the UK's Chartered Institute of Purchasing and Supply and the US Institute of Supply Management, and will be launched in 2010.

Education and early careers

Education programmes in our home markets aim to interest young people in science and engineering, and tackle perceptions that engineering is a male career choice. In the UK, our schools road show is in its fifth year, while in the US we continue to be a strategic partner with FIRST (For Inspiration and Recognition of Science and Technology) to encourage youth excitement for science, technology, engineering and mathematics through robotics competitions.

Other examples from across the Group are as follows:

- Concept2Creation in Australia encourages under 16s to work with teachers and Group employees to develop a product or service
- In South Africa, the Group supports the education of children from disadvantaged backgrounds as part of the South African government's initiative to create a more equitable society
- BAE Systems is a lead sponsor of the Big Bang event, the UK's largest ever national science, technology and engineering fair for young people and teachers, attended by over 6,500 people

The Group partners with universities to develop courses that meet the needs of our industry and provide placement opportunities for undergraduates. As a partner in the development of the UK government's new Diploma in Engineering for 14-19 year olds, the Group is helping to ensure the programme addresses employers' needs and puts students in a stronger position when they enter the job market.

We invest in recruiting and developing young people through our graduate and apprenticeship programmes. In the UK, 352 graduates joined the Group in 2009 and we are one of the biggest recruiters of engineering apprentices, employing 283 new apprentices in the UK in 2009.

WORKPLACE

We work to ensure that BAE Systems has the right employees with the right skills to serve customers in all our markets, now and in the future. This activity is being delivered against a backdrop of skills shortages in some areas of our industry, and intense competition for science and engineering graduates in many of our home markets.

An inclusive workplace where all individuals are valued and respected, encourages innovation, supports the retention of skilled employees and increases our attractiveness as an employer to potential recruits. Training and leadership programmes help us to develop the capabilities needed in a changing marketplace and to support employees from all backgrounds to reach their full potential. We invest in the skills of our next generation of employees through our education and early careers programmes.

Community involvement

Support for charities and community organisations helps foster good relationships with the communities near our sites in the countries in which we work. Providing opportunities for employees to volunteer and fundraise for charity contributes to job satisfaction and a positive working environment.

The Company Giving Policy focuses on supporting the armed forces, veterans and their families, as well as education projects with a science, engineering and technology focus.

The Group makes donations to local, national and international charities, and other not-for-profit organisations.

Charity Challenge is our Group-wide employee fundraising and volunteering programme. In the UK, US and Australia, employees elect partner charities for 18-month periods. During 2008/2009, our partner charities were Sue Ryder Care (UK), Leukaemia Foundation (Australia) and America Supports You (US).

Our total community investment (including our education programmes) was £13.8m in 2009.

2009 performance

During 2009, we held a number of workshops attended by senior management and functional groups to develop our inclusion agenda.

Our Operational Framework was reviewed to ensure it reflects the Group's commitment to inclusion, and ensure it encourages the behaviours and culture needed to underpin the Code of Conduct. Senior leadership each committed to a personal inclusion objective, such as mentoring, supporting women's network events and leading focus groups with minority employee groups.

A Global Diversity and Inclusion Working Group was launched in 2009 to co-ordinate our approach to diversity and inclusion. A five-level Diversity and Inclusion Maturity Matrix has been developed. This establishes a consistent global benchmark, helping our operating groups to chart their progress from meeting regulatory requirements (Level 1) to creating a culture that embraces diversity as a source of competitive advantage (Level 5). During 2010, each operating group will set targets against the matrix reflecting their different stages of development.

Responding to employee feedback

Following the 2008 employee opinion survey, the Executive Committee agreed four performance improvement priorities in response to feedback from employees

Progress in the four areas during 2009 includes

Improvement priority	Progress in 2009
Personal performance objectives should be clear and measurable	Operating groups continue to improve performance objectives. In particular, mid-year personal development reviews are used to refine objectives
Properly recognise people for doing a good job	Efforts to ensure that managers across the Group are aware of tools they can use to recognise employee achievements
Business changes that affect us should be communicated in a timely manner	Operating groups are continuing to improve communication from senior leaders on business changes
Our working culture should enable everyone to demonstrate high standards of business conduct, and to speak up and challenge inappropriate behaviour	The roll-out of our Code of Conduct has focused on creating an environment where employees feel they can speak up and raise any concerns

ASSURANCE

Deloitte LLP have been engaged to provide assurance of CR data as follows

- Reasonable assurance of business conduct performance data (number of staff briefed, trained and who acknowledged the Code, and calls to the Ethics Helpline), and
- Limited assurance of other performance data relating to safety (fatalities, major injuries (number and rate) and lost work day case rate), business conduct (dismissals for reasons relating to unethical behaviour) and HR data (gender, ethnicity and age diversity)

Deloitte's independent assurance report is published within the BAE Systems 2009 Corporate Responsibility Report at www.baesystems.com/cr09/

CORPORATE RESPONSIBILITY PERFORMANCE SUMMARY

Data on business conduct, safety, environment, and diversity and inclusion is collected by the businesses and collated centrally for review

	2006	2007	2008	2009
Business conduct				
Ethics enquiries from employees	410	327	507	870
Employees ¹ briefed and trained on the Code of Conduct (KPI)	n/a	n/a	n/a	95%
Written acknowledgement received from employees ¹ on Code of Conduct (KPI)	n/a	n/a	n/a	86%
The increase in the number of enquiries reflects the Group's continued focus on awareness and training relating to business conduct following the roll-out of the Code of Conduct in 2009. Activity continues to ensure that the remaining employees complete the Code of Conduct programme				

Safety

Lost work day case rate (per 100,000 employees) (KPI)	557	554	789	562
The Group exceeded its target of a 10% improvement in the gap between 2008 lost work day case rate performance and the best in class target of 100 per 100,000 employees				
We have discontinued reporting total recorded injuries to all employees this year as this figure is not readily comparable with other companies				

Environment

Total CO ₂ emissions (thousand tonnes)	n/a	920	1,190	*
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* The Coefficient Company has been commissioned to calculate the Group's 2009 carbon footprint the results of which were not available at the date of this report.

The reported increase in the Group's carbon footprint in 2008 reflects improvements in data collection and acquisition activity. The energy use and CO₂ emissions relating to energy use metrics presented in last year's report have been replaced by one metric on total CO₂ emissions. Data on volatile organic compound emissions are no longer collated at a Group level.

Diversity and inclusion

Gender diversity:				
Male employees	80%	79%	80%	80%
Female employees	20%	21%	20%	20%
Ethnic diversity:				
White	87%	82%	85%	85%
Non-white	13%	18%	15%	15%
Age diversity				
Under 25	7%	8%	10%	8%
26-35	18%	17%	17%	19%
36-49	42%	39%	38%	37%
50-59	26%	27%	27%	28%
60+	7%	9%	8%	8%

Ethnic diversity figures are based on South Africa, UK and US data only

¹ Wholly-owned subsidiaries only, excluding employees on long-term absence

RISK MANAGEMENT

Effective management of risk and opportunity is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value and protection of its reputation.

BOARD REVIEW

REPORTING / MONITORING

BOARD COMMITTEE REVIEW

EXECUTIVE COMMITTEE REVIEW

– Audit Committee review – Corporate Responsibility Committee review

REPORTING / MONITORING

ASSURANCE / SELF-ASSESSMENT

OPERATIONAL FRAMEWORK

Total Performance

Organisation

Governance

Core Business Processes

Delegated Authorities

Mandated Policies
Processes and Charters

BAE Systems Businesses

BUSINESS RISK MANAGEMENT

IDENTIFICATION

- Full risk review undertaken at least six-monthly by each business and function
- Both financial and non-financial risks recorded in controlled registers
- Risk owners allocated to assess and manage risk

ANALYSIS

- Risks analysed for impact and probability to determine gross exposure

MITIGATION

- Risk owners identified
- Action plans implemented to manage, or respond to, risks
- Robust mitigation strategy subject to regular and rigorous review

EVALUATION

- Risk exposure reviewed and risks prioritised
- Risk evaluation documented in controlled risk registers

REPORTING AND MONITORING

- Risks and mitigation plans monitored, and rigorously reviewed regularly
- Significant risks immediately notified through the business reporting systems
- Key risks reported through Quarterly Business Reviews, twice-yearly through the Operational Assurance Statement self-assessment and annually through the Integrated Business Plan
- Risk workshops conducted by the Executive Committee to analyse and allocate management responsibility for managing significant non-financial risks
- Risks reviewed by the Board, and its Audit and Corporate Responsibility Committees on a regular basis

PRINCIPAL RISKS

	page
– Defence spending	48
– Large contracts	48
– Government contracts	48
– Contract timing	48
– Fixed-price contracts	49
– Component availability, subcontractor performance and key suppliers	49
– Global market	49
– Export controls and other restrictions	50
– Consortia and joint ventures	50
– Competition	50
– Pension funding	50
– Acquisitions	51
– Laws and regulations	51
– Exchange rates	51

BUSINESS RISK IDENTIFICATION

Annually	Core Business Process Integrated Business Plan
Six-monthly	Mandated Policy Operational Assurance Statement
Quarterly	Core Business Process Quarterly Business Review
Monthly	Core Business Processes Lifecycle Management Contract reviews

Effective management of risks and opportunities is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value and protection of its reputation. The Group's approach to risk management is aimed at the early identification of key risks, and then removing or reducing the likelihood and effect of risks before they occur, and dealing effectively with them 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 committed to the effective management of material non-financial and reputational risks, including those arising in connection with safety and ethical issues.

Reporting and monitoring

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 social, environmental, ethical and reputational risk.

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.

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 most significant non-financial risks to the Group. The non-financial risk register is also reviewed regularly by the Executive Committee to monitor the ongoing status and progression of mitigation plans. In addition, it is also reviewed on a regular basis by the Board and Corporate Responsibility Committee.

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

In light of the global economic environment, an additional risk in respect of the Group's dependence on component availability, subcontractor performance and key suppliers has been disclosed this year (see page 49).

p78 to p92 FOR MORE INFORMATION ON THE ACTIVITIES OF THE BOARD AND ITS COMMITTEES SEE THE CORPORATE GOVERNANCE SECTION

p83 to p84 FOR MORE INFORMATION ON OUR BUSINESS PROCESSES AND MANDATED POLICIES SEE THE CORPORATE GOVERNANCE SECTION

PRINCIPAL RISKS

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-related, selling products and services directly and indirectly primarily to the US, the UK, the Saudi Arabian and other national governments. In any single market, 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.

Although the Group expects growth in US defence spending to slow, it believes it is well placed to support the US Department of Defense's likely emphasis on force sustainment, readiness and affordable transformation. The UK defence equipment budget is expected to continue to be constrained, having

potential implications for the sustainability of long-term funding for future defence technologies and engineering capabilities in the UK. Saudi Arabia is expected to remain one of the heaviest defence spenders in the world.

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 seven home markets and its products are marketed across a range of sectors within the defence arena. In addition, the Group uses realistic assumptions to underpin its financial and operational planning.

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. These contracts individually are typically worth or potentially worth £1bn or more including, but not limited to, those contracts in the Programmes & Support and International operating groups.

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. An analysis of the Group's order book by major programme and operating group is presented on page 13. 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 (refer to Strategy section on page 10).

GOVERNMENT CONTRACTS

The Group's largest customer contracts are government contracts

Description The governments of the United Kingdom, the United States and the 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. Moreover, companies engaged in the supply of defence-related equipment and services to government agencies are subject to certain business risks particular to the defence industry. These governments could unilaterally cancel, suspend or amend their contractors' funding under existing contracts or eligibility for new contracts potentially at short notice. 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 (refer to Strategy section on page 10).

CONTRACT TIMING

The timing of contracts 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.

FIXED-PRICE CONTRACTS

The Group has fixed-price contracts.

Description A significant portion of the Group's revenue is derived from fixed-price contracts, although the Group has reduced its exposure to fixed-priced design and development activity which is in general more risk intensive than fixed-price production activity. 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.

Impact The Group's failure to anticipate technical problems, estimate costs accurately or control costs

during performance of a fixed-priced contract may reduce the profitability of such a contract or result in a loss.

Mitigation: To manage contract-related risks and uncertainties, contracts are managed through the application of the Lifecycle Management (LCM) business process mandated by the Group's Operational Framework at the operational level (refer to pages 15 and 84 for further information on LCM). The consistent application of metrics is used to support the review of individual contract performance (refer to page 28 for KPIs relating to programme execution).

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 current economic environment and constraints on available financing, which could impair their ability to meet their obligations to the Group. In addition, some products require relatively scarce raw materials. The Group is generally subject to specific procurement requirements, which may, in effect, limit the suppliers and subcontractors the Group may utilise. In some instances, the Group is dependent on sole-source 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. While the Group enters into long-term or volume purchase agreements with certain suppliers and takes other actions to ensure the availability of needed materials, components and subsystems, the Group cannot

be sure that such items will be available in the quantities the Group requires, if at all. If the Group experiences a material supplier or subcontractor problem, its ability to satisfactorily and timely complete its customer obligations could be negatively impacted which could result in reduced sales, termination of contracts and damage to its reputation and relationships with its customers. The Group could also incur additional costs in addressing such a problem. Any of 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. In light of global economic conditions, the Group has reviewed strategically important suppliers globally to assess their financial health.

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 with seven home markets.

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. Many of the products the Group designs and manufactures for military or dual use are considered to be of national strategic interest. The export of such products outside the jurisdictions in which they are produced is normally 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 and other penalties, including potential restrictions on trading.

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

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.

COMPETITION

The Group's business is subject to significant competition

Description Most of the Group's businesses are focused on the defence industry 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 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.

Additionally, 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. Therefore, other defence companies may have an advantage over the Group for some defence-related contracts on the basis of the jurisdiction in which they are organised, where the majority of their assets are located or where their officers or directors are located.

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 strong global market positioning, balanced portfolio, leading capabilities and performance continue to address this risk (refer to pages 16 to 19 for further information on the Group's positioning and portfolio).

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 projected liabilities of these schemes and the value of the assets they hold. The Group has put in place and is implementing deficit recovery plans in line with agreements reached with the respective scheme trustees based on actuarial advice and valuation results.

Impact: The amount of the deficits may be adversely affected by a number of factors, including lower than assumed investment returns, changes in long-term interest rate and price inflation expectations, and greater than

anticipated improvements in members' longevity. An increase in pension scheme deficit 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 obligations or business needs.

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 (refer to page 150 for further details of the Group's retirement benefit plans).

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. Integrating the operations and personnel of acquired businesses is a complex process. The Group may not be able to integrate the operations of acquired businesses with existing operations rapidly or without encountering difficulties.

Impact The diversion of management attention to integration efforts and any difficulties encountered in combining operations could adversely affect the Group's business. The failure to manage growth by acquisition while at the same time maintaining adequate focus on the

existing assets of the Group could have a material adverse effect on the Group's business, future results of operations or financial condition. In addition, failure to integrate acquisitions appropriately creates the risk of impairments arising on goodwill and other intangible assets.

Mitigation The Group has an established methodology in place to deliver the effective integration of acquisitions. The Group has an established policy for monitoring impairment risks. See note 1 to the Group accounts on page 125 for further information on the Group's approach to impairment testing.

LAWS AND REGULATIONS

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

Description The Group's operations are subject to numerous domestic and international laws, regulations and restrictions. Non-compliance with these laws, regulations and restrictions could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group. The Group has contracts and operations in many parts of the world and operates in a highly regulated environment. The Group is subject to the laws and regulations of many jurisdictions, including those of the UK and US. These include, without limitation, regulations relating to import-export controls, money-laundering, false accounting, anti-bribery and anti-boycott provisions. 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 to its resources dedicated to its 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. Policies and procedures for the appointment of advisers engaged in business development have been further refined, and a uniform global policy and process has been established. In the settlement reached with the US Department of Justice in February 2010 in connection with its investigation commenced in 2007, the Company made commitments to the Department of Justice concerning the Group's ongoing regulatory compliance, including the appointment of an independent monitor for a period of up to three years to monitor the Company's compliance with such commitments.

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, as well as to manage anticipated economic cash flow exposures over the medium term. The Group aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material foreign currency 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.

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.

4. Segmental performance

The Group Strategic Objective is Total Performance through Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour

Operating group performance summary	54
Electronics, Intelligence & Support	56
Land & Armaments	60
Programmes & Support	64
International	68
HQ & Other Businesses	72

BAE SYSTEMS INFORMATION SOLUTIONS

BAE Systems Information Solutions, part of the Electronics, Intelligence & Support operating group, monitors network operations across the US from its Network Operations Centre in Herndon, Virginia

OPERATING GROUP PERFORMANCE SUMMARY

A diverse yet balanced portfolio of businesses

The Group has four principal operating groups organised around a combination of the different products and services they provide, and the geographical areas in which they operate

Ian King
Chief Executive, BAE Systems plc

ELECTRONICS, INTELLIGENCE & SUPPORT

p56

"The operating group 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 has a track record of delivering growth from its long-standing culture of innovation

Its order book comprises several thousand contracts, with diverse delivery periods ranging from months to multiple decades "

Mike Heffron President, Electronics, Intelligence & Support

LAND & ARMAMENTS

p60

"The operating group represents one of the leading land systems businesses in the world with operations at more than 50 sites across the UK, US, South Africa and Sweden. Its primary focus is to provide technology solutions, world-class systems integration and flexible manufacturing capabilities, as well as superior integrated logistics support

throughout the product lifecycle. The operating group maintains industry leadership in advanced technologies that focus on enhancing survivability, mobility and lethality, with an order book comprising contracts with customers in more than two dozen countries "

Bob Murphy President, Land & Armaments

PROGRAMMES & SUPPORT

p64

"The operating group delivers design, manufacture and through-life support programmes for military and security customers in over 50 countries. It primarily comprises the Group's UK-based air, naval and security activities. The operating group has a strong long-term order book underpinned by the major air production and support programmes, Typhoon, F-35, Nimrod, Gripen, Tornado and Harrier, and within

the naval domain, the Astute Class submarine programme, the Type 45 destroyer programme and the Queen Elizabeth Class aircraft carriers. Effective delivery of the order book and the transition of production relationships into through-life support contracts, together with the continued evolution of the security strategy, drives the future development of this business "

Nigel Whitehead Group MD Programmes & Support

INTERNATIONAL

p68

"The operating group's CS&S International business predominantly acts as prime contractor for the UK government-to-government defence agreement with Saudi Arabia and has a major in-country presence. Its main activities include operational capability support to both the Royal Saudi Air Force and Royal Saudi Naval Force and, more recently, the commencement of supply of 72 Typhoon aircraft.

BAE Systems Australia is the largest defence contractor in Australia following the acquisition

of Tenix Defence in 2008. The business offers capability across the aerospace, land and maritime domains.

The operating group also has joint venture shareholdings in MBDA (37.5%), Saab (20.5%) and Air Astana (49%). A new land systems business in India, the Group's seventh home market, is in the process of being established through the formation of a joint venture with Mahindra & Mahindra (26%) "

Guy Griffiths Group MD, International

Linda Hudson
Chief Operating Officer,
President and CEO of
BAE Systems Inc

The charts below illustrate the contribution of each of the four operating groups to the Group's sales^{1,3} and underlying EBITA² in the year. The tables below provide a reconciliation of the performance of the individual operating groups to the Group's results, discussed in the Financial review on pages 30 to 37.

Sales¹, underlying EBITA², cash flow⁵ and order intake¹ are Group KPIs. See pages 26 and 27 for a review of these KPIs on a Group basis.

SALES^{1,3} BY OPERATING GROUP⁴ (%)

UNDERLYING EBITA² BY OPERATING GROUP⁴ (%)

OPERATING GROUP PERFORMANCE SUMMARY 2009

	(KPI) Sales ¹ £m	(KPI) Underlying EBITA ² £m	Return on sales %	(KPI) Cash flow ⁵ £m	(KPI) Order intake ¹ £m	Order book ¹ £bn
Electronics, Intelligence & Support	5,637	575	10.2	380	5,416	4.5
Land & Armaments	6,738	604	9.0	480	3,934	7.8
Programmes & Support	6,298	670	10.6	285	8,789	24.3
International	4,253	442	10.4	816	4,825	11.6
HQ & Other Businesses	254	(71)		(366)	175	0.4
	23,180	2,220		1,595	23,139	48.6
Intra-group	(765)	–		–	(1,170)	(1.7)
	22,415	2,220	9.9	1,595	21,969	46.9

OPERATING GROUP PERFORMANCE SUMMARY 2008

	(KPI) Sales ¹ £m	(KPI) Underlying EBITA ² £m	Return on sales %	(KPI) Cash flow ⁵ £m	(KPI) Order intake ¹ £m	Order book ¹ £bn
Electronics, Intelligence & Support	4,459	506	11.3	380	4,904	5.2
Land & Armaments	6,407	566	8.8	467	8,568	11.5
Programmes & Support	4,638	491	10.6	651	4,195	19.8
International	3,333	435	13.1	163	4,065	11.0
HQ & Other Businesses	235	(101)		(66)	212	0.4
	19,072	1,897		1,595	21,944	47.9
Intra-group	(529)	–		–	(635)	(1.4)
	18,543	1,897	10.2	1,595	21,309	46.5

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 the Financial review on page 30)

3 Before elimination of intra-group sales

4 Excluding HQ & Other Businesses

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

ELECTRONICS, INTELLIGENCE & SUPPORT

FINANCIAL HIGHLIGHTS

- Like-for-like organic sales¹ growth of 6% over 2008
- Underlying EBITA² excludes a non-recurring accounting gain of £202m from the restructuring of the US pension schemes

PERFORMANCE

	2009	2008	2007
Sales ¹	£5,637m	£4,459m	£3,916m
Underlying EBITA ²	£575m	£506m	£437m
Return on sales	10.2%	11.3%	11.2%
Cash inflow ³	£380m	£380m	£302m
Order intake ¹	£5,416m	£4,904m	£4,178m
Order book ¹	£4.5bn	£5.2bn	£3.5bn

Mike Heffron President, Electronics, Intelligence & Support

The Electronics, Intelligence & Support operating group, with 32,000 employees¹ and headquartered in the US, designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications.

The operating group comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions.

KEY POINTS

- Maintained leadership position in electronic warfare systems
- Introduced new infrared technology solutions to improve the effectiveness of US Army troops
- Secured seven-year managed IT services contract for the US Treasury
- Expanded leadership position in hybrid electric propulsion for urban mass transit buses
- Selected to provide US military counter-insurgency support services under a five-year urgent-needs contract

LOOKING FORWARD

BAE Systems remains focused on winning strategic contracts in information technology, cyber, mission support and services. The business continues to capitalise on its leadership positions in electronic warfare and infrared technologies, and expand its diverse mix of commercial and civil government businesses in areas such as ship repair, information technology and commercial aviation. It also continues to invest in the growing fields of energy management, Readiness & Sustainment services and cybersecurity.

SALES¹ BREAKDOWN

ORGANIC SALES¹ GROWTH

6%

Like-for-like sales¹ growth

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 the Financial review on page 30)
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust.

COMMON MISSILE WARNING SYSTEM (CMWS)

BAE Systems' CMWS has achieved more than one million combat flight hours across some 1,800 systems, providing US Army aircraft with protection against infrared-guided missiles during combat operations in Iraq and Afghanistan

Power management

Our efficient, low-emission HybriDrive® propulsion technology has been in service on buses since 1998. It is currently powering more than 2,000 buses and transporting over a million passengers daily in cities in North America and London. To date, these buses have accumulated more than 100 million miles, saved nearly 10 million gallons of diesel fuel, and prevented more than 100,000 tons of carbon emissions.

In 2009, Electronics, Intelligence & Support (EI&S) achieved sales¹ of £5,637m (2008 £4,459m). On a like-for-like basis, sales¹ growth was 6% over 2008.

Underlying EBITA² of £575m (2008 £506m) excludes a non-recurring accounting gain of £202m from the restructuring of the US pension schemes. Return on sales reduced to 10.2% (2008 11.3%). In 2008, there was a credit of £23m from share scheme mark-to-market accounting.

Operating cash inflow³ was £380m (2008 £380m).

Electronic Solutions

Electronic Solutions continued to demonstrate its leadership position in the electronic warfare market through Low-Rate Initial Production (LRIP) awards for electronic warfare suites on the F-35 Lightning II. During 2009, orders totalled more than \$220m (£136m). Deliveries on the first four LRIP contracts will conclude in 2012, and future contract awards are anticipated to support aircraft deliveries to the US government and international partner countries.

US Army demand for thermal weapon sights drove deliveries of some 36,000 systems valued at \$340m (£217m) in 2009 under the five-year Indefinite-Delivery/Indefinite-Quantity (IDIQ) contract. Cumulative orders for these weapon sights exceed \$500m (£310m) for 68,000 sights.

US Army orders for the Common Missile Warning Systems (CMWS) totalled more than \$100m (£62m) in 2009. CMWS is a helicopter missile warning system that detects incoming missiles, rejects false alarms, and cues the onboard infrared jamming system to the missile's location. The system logged its millionth combat flight hour during the year.

Two IDIQ contracts were received from the US Army for the Laser Target Locator Module and the Driver's Vision Enhancer Family of Systems. The lightweight target locators enable soldiers to quickly, safely and accurately determine target coordinates in daylight or darkness, and the vision enhancement systems provide all-weather, day/night visibility to operators of combat and logistics vehicles. Initial orders for the two systems totalled \$115m (£71m) in 2009.

The US Navy selected a BAE Systems-Alliant Techsystems team for the Joint and Allied Threat Awareness System (JATAS) technology demonstration. JATAS is the next-generation missile warning system to protect US Navy and Marine Corps helicopters and tilt-wing aircraft.

Information Solutions

Some two-thirds of the line of business's activity is in support of the US intelligence community.

The Information Solutions business also positioned itself among the largest providers of managed information technology services, receiving a seven-year contract to manage Information Technology (IT) operations for the US Treasury, valued at up to \$325m (£201m).

The business received a contract for up to \$148m (£92m) from the US Department of Homeland Security to support the agency's fingerprint image tracking programme.

In the government intelligence market, Information Solutions emerged as a leader in analysis of full-motion video and other advanced imagery, doubling the number of its own imagery analysts, and opening a facility to train analysts for the military and intelligence communities.

BAE Systems' prominent role in the information technology sector was recognised by Computerworld magazine which named the business one of the top 100 IT employers in the US.

Platform Solutions

Platform Solutions further expanded its leadership in hybrid propulsion for urban mass transit. The HybriDrive® propulsion system made its European debut, demonstrated on vehicles in partnership with UK-based manufacturer, Alexander Dennis Limited. As part of a Transport for London trial programme, BAE Systems has hybrid propulsion systems for 12 double-deck and five single-deck buses.

The business is well positioned for a hybrid bus production order for London's transit fleet in 2010. The efficient, emissions-reducing hybrid technology now powers more than 2,000 buses in North America and will

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 the Financial review on page 30).

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

Laser Target Locator Modules

BAE Systems has been awarded a five-year Indefinite-Delivery/Indefinite-Quantity contract to produce Laser Target Locator Modules for the US Army. The system provides an all weather, lightweight, handheld laser target locator system that allows soldiers to accurately identify target locations while on foot, in daylight or at night, and in fog or smoke.

Coyote Unmanned Aircraft System

BAE Systems, in partnership with the National Oceanic and Atmospheric Administration (NOAA), completed the first successful test flight of its small, electric-powered Coyote Unmanned Aircraft System. The lightweight aircraft can be equipped with sensors or cameras to perform intelligence, surveillance and reconnaissance missions while the host aircraft remains in safe airspace. It also has potential uses in weather forecasting. NOAA funded the test flight, a major step forward for this innovative and one-of-a-kind system.

enter the Seattle transit fleet in 2010 following the award of a contract from Daimler Buses North America which received a 500-unit order (with an option for 200 additional units) from the Seattle Transit Agency.

Following the US Army's development of the Common Modular Power System as its standard power management architecture for all legacy and modern vehicles, the business received its first production contract in support of the Paladin self-propelled howitzer.

Platform Solutions received the launch order for its holographic pilot display technology. The UK Ministry of Defence selected the Q-Sight™ helmet-mounted display for its Lynx helicopter programme, a development that positions the business for an expanded role in low-visibility operation of rotary wing aircraft. The technology provides superior optical performance with reduced weight and cost.

Support Solutions

The US military's Human Terrain Teams programme awarded the business a \$350m (£217m), five-year contract to support urgent needs for recruitment, development and operational support of counter-insurgency efforts. Human Terrain Teams embed social scientists within combat brigades to help tacticians in field environments understand local cultures.

A \$320m (£198m), five-year US Army contract was received to provide counter-Improvised Explosive Device (IED) operations and mission support covering comprehensive, all-source intelligence analysis to assist in the global counter-IED fight.

The US Navy awarded a \$233m (£144m) contract for engineering and other services to support C4ISR (Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance) systems at land-based facilities, and on platforms such as ships, submarines and ground vehicles.

In the Ship Repair business, the US Navy's first ever full ship modernisation was completed, a year-long, \$31m (£19m) upgrade of the USS Bunker Hill. The maintenance, repair and modernisation programme was concluded on time and met all critical milestones.

LAND & ARMAMENTS

FINANCIAL HIGHLIGHTS

- Underlying EBITA² excludes a non-recurring accounting gain of £59m from the restructuring of the US pension schemes
- Underlying EBITA² includes £42m of costs associated with the unsuccessful Mine Resistant Ambush Protected (MRAP) All-Terrain Vehicle (ATV) bid that were expensed in the year
- Impairment charges of £927m mainly on the Family of Medium Tactical Vehicles (FMTV) programme and Products Group business

PERFORMANCE

Bob Murphy President Land & Armaments

The Land & Armaments operating group, with 19,800 employees¹ and headquartered 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.

	2009	2008	2007
Sales ¹	£6,738m	£6,407m	£3,538m
Underlying EBITA ²	£604m	£566m	£324m
Return on sales	9.0%	8.8%	9.2%
Cash inflow ³	£480m	£467m	£10m
Order intake ¹	£3,934m	£8,568m	£4,535m
Order book ¹	£7.8bn	£11.5bn	£7.3bn

KEY POINTS

- Organisation realigned with global strategy
- High volume of vehicle reset and support activity
- Improving performance through rationalisation and efficiencies
- Loss of follow-on production contract for FMTV

LOOKING FORWARD

In the near term, Land & Armaments will be operating in an increasingly challenging market, brought about by shifting national priorities and pressure on defence budgets, particularly in our US and UK markets. The rest of world market is expected to provide export opportunities over the same period. The business is being shaped to perform in these market conditions through an ongoing drive for rationalisation and efficiency.

SALES¹ BREAKDOWN

ORGANIC SALES¹ REDUCTION

–8%

Like-for-like reduction in sales¹

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 the Financial review on page 30)
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust

BVS10 VIKING

BAE Systems will deliver an improved version of its go-anywhere BvS10 Viking armoured vehicle to the UK Ministry of Defence in 2010 for deployment to Afghanistan. Lessons learned from operations in Afghanistan have resulted in several improvements to the vehicle including levels of protection, a larger and more powerful engine, and a bigger alternator which provides more electrical power.

Bradley

Land & Armaments continues to focus on Readiness & Sustainment activity. In 2009, the US Army awarded BAE Systems a contract to refurbish some of its heavy infantry vehicles. Through a public-private partnership, BAE Systems will repair and upgrade 606 Bradley Fighting Vehicles. This process mitigates the effect of combat use, replaces battle damaged vehicles and provides the military with vehicles in pre-deployment condition.

In 2009, Land & Armaments achieved sales¹ of £6,738m (2008 £6,407m). On a like-for-like basis, sales were 8% below 2008 reflecting the lower level of land vehicle sales, primarily on the Mine Resistant Ambush Protected (MRAP) programme, which totalled £0.2bn in 2009 (2008 £1.7bn).

Underlying EBITA² was £604m (2008 £566m), which excludes a non-recurring accounting gain of £59m from the restructuring of the US pension schemes. Excluding costs of £42m associated with the unsuccessful MRAP All-Terrain Vehicle (ATV) bid that were expensed in the year, return on sales increased to 9.6% (2008 8.8%).

Operating cash inflow³ was £480m (2008 £467m).

Order intake¹ was £3,934m (2008 £8,568m). Intake in 2008 included significant awards for the 15-year UK munitions capability contract and Family of Medium Tactical Vehicles (FMTV).

United States

BAE Systems continued in its role as a premier combat systems supplier to the US Army Heavy Brigade Combat Team (HBCT), providing remanufacturing, reset and support for key brigade components. BAE Systems was awarded \$791m (£490m) of contracts for Bradley Fighting Vehicles and \$277m (£172m) of contracts for Hercules M88 Recovery Vehicles during 2009 while delivering more than 1,500 completed vehicles to the customer.

The business was awarded an initial \$64m (£40m) Paladin Integrated Management contract to modernise the M109A6 Paladin self-propelled howitzer system, including the design, fabrication and testing of five prototypes and two support vehicles.

BAE Systems continued to build the FMTV trucks with contracts for approximately \$2bn (£1.2bn) per year to the end of 2010. Some 8,400 trucks were manufactured and delivered to the US Army in 2009.

A setback for the Group was the notification by the US Department of Defense in August 2009 and, following a re-evaluation of the bids, in February 2010 that a follow-on production contract for vehicles under the FMTV programme had been lost.

A new Euro V-compliant Global Tactical Vehicle has been designed and produced to address European market requirements. The vehicle was unveiled at the biennial Defence Systems & Equipment international exhibition in the UK in September.

The personnel security business secured over \$371m (£230m) of contracts for individual soldier protection, with contracts for Modular Lightweight Load Carrying Equipment from the Defense Logistics Agency as well as contracts for over 230,000 Outer Tactical Vests.

As part of the ongoing realignment of the Land & Armaments business in the US, the business has implemented rationalisation programmes reducing headcount by 12% and the closure of seven facilities.

United Kingdom

Under the 15-year munitions partnering agreement with the UK Ministry of Defence (MoD), delivery rates on small arms ammunition continued at an average of one million rounds per day in support of current operations. As committed under the agreement, £15m has been invested so far in new manufacturing operations out of the total programme for more than £120m.

Significant work is underway to support operations in Afghanistan, particularly in carrying out urgent operational upgrade work to vehicles such as the Warrior and the new Panther, to continue to protect against rapidly evolving threats.

The business submitted competitive bids into both the Future Rapid Effects System (FRES) Specialist Vehicle (SV) and Warrior upgrade programmes, the outcomes of which are currently expected to be known in 2010.

The BAE Systems turret design is optimised for the new cased-telescoped ammunition weapon system, the CT40, which was mandated by the UK MoD for both the Warrior and FRES SV programmes.

With a new schedule on the Terrier armoured tractor programme agreed at the end of 2008, the MoD confirmed the production of 60 vehicles with enhancements to improve protection beyond the original design. Production began in early 2010.

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 the Financial review on page 30).

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

M777

BAE Systems celebrated delivery of the 500th M777 howitzer to the US military in 2009. The M777 is the world's first artillery weapon to make widespread use of titanium and aluminum alloys, resulting in a howitzer which is half the weight of conventional 155mm systems. The total number of orders is over 850 in a programme worth over £1bn since it began in the mid-1990s.

The business received new orders for the production and support of the M777 155mm lightweight howitzer, for both the US and Canadian armed forces. A total of 158 M777s were delivered in 2009. The M777 system has been deployed on operations in both Afghanistan and Iraq.

As part of its ongoing restructuring, the business announced over 500 job losses and the closure of three sites.

Sweden

Contracts for 24 BvS10 Viking amphibious all-terrain vehicles were awarded by the UK MoD for a value of £16m. All 24 will be of the new up-armoured MkII variant. In December, the BvS10 was selected following a competition to supply vehicles to the French armed forces and a contract for up to €220m (£196m) was awarded.

Export deliveries continued for CV90 vehicles and support to several customers around the world, including the Netherlands, Denmark and Sweden.

The 155mm Archer self-propelled artillery system has been selected and confirmed by both Sweden and Norway with contracts for a total of 48 systems expected to be signed in early 2010.

A successful legal appeal was made against the decision of the Swedish Defence Materiel Administration (FMV) in June 2009 to choose a competitor's vehicle for the Armoured Wheeled Vehicle programme. The Administrative Court of Stockholm ruled in October that the FMV must re-compete the procurement. The outcome of the competition is currently expected in 2010.

The Swedish businesses have announced job losses in 2009, totalling approximately 350, as a consequence of restructuring activity.

Helping to raise awareness of careers in engineering

In Minneapolis, to help raise awareness of careers in engineering, we run a Minorities & Women in Technology Programme, to provide female and minority students who are interested in engineering and technology with an opportunity to see engineering principles applied in a real-life work setting. Our engineering employees mentor students and lead them through a 20-week programme. The students work side-by-side with engineers from various disciplines and during the programme rotate across different fields of engineering to see how we deliver a final product to the customer.

South Africa

The South African business continued to deliver RG vehicles to several customers around the world, including completing the delivery of RG32M vehicles to Sweden, RG31 vehicles to Spain and RG31 MRAP vehicles to the US.

Building on the success of the RG range of vehicles, a new vehicle, the RG35, has been designed and built. The RG35 is a 6x6 mine protected multi-purpose fighting vehicle and was launched to the market in September.

PROGRAMMES & SUPPORT

FINANCIAL HIGHLIGHTS

- Sales¹ increased over 2008 on commencement of aircraft deliveries and support on the Saudi Typhoon programme, increased deliveries of the Typhoon Tranche 2 standard, and a full year of Detica sales
- Underlying EBITA² increased by 36%
- £8.8bn of orders¹ booked in the year, increasing order book¹ to £24.3bn

PERFORMANCE

	2009	2008	2007
Sales ¹	£6,298m	£4,638m	£5,327m
Underlying EBITA ²	£670m	£491m	£456m
Return on sales	10.6%	10.6%	8.6%
Cash inflow ³	£285m	£651m	£807m
Order intake ¹	£8,789m	£4,195m	£9,091m
Order book ¹	£24.3bn	£19.8bn	£20.9bn

Nigel Whitehead Group Managing Director, Programmes & Support

The Programmes & Support operating group, with 33,200 employees¹, primarily comprises the Group's UK-based air, naval and security activities.

KEY POINTS

- Typhoon Tranche 3A secured
- Over £3bn of support orders received
- Astute submarine commenced sea trials
- Second Type 45 accepted off contract
- Acquisition of VT Group plc's 45% interest in the BVT joint venture, now 100% owned and re-named BAE Systems Surface Ships
- Detica security business performing strongly in the first full year since acquisition
- Continued rationalisation activity

LOOKING FORWARD

Programmes & Support is driven by its existing strong order book, and the level of future UK Ministry of Defence (MoD) funding to meet current UK armed forces operational requirements and delivery of the Defence Industrial Strategy. A Strategic Defence Review will begin after the general election in 2010.

In Military Air Solutions, growth is linked to increased combat aircraft production activity and in-service support performance.

Surface Ships is underpinned by the six-ship Type 45 destroyer programme, the manufacturing phase of the Queen Elizabeth Class carrier programme, export contracts and the 15-year Terms of Business Agreement with the UK MoD.

The Submarine Solutions business remains focused on the Astute programme, and on delivering the concept design work for the Successor Programme. Follow-on orders for Astute are key to retaining the skill base necessary to design and build a next-generation nuclear deterrent submarine.

Detica's reputation in the UK security market, repositioning to become a solution integrator and the publication of the UK government cybersecurity strategy, mean the business is positioned to benefit from continued government focus on intelligence, security and resilience.

SALES¹ BREAKDOWN

ORGANIC SALES¹ GROWTH

33%

Like-for-like sales¹ growth

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 the Financial review on page 30)
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust.

TYPE 45 DESTROYER PROGRAMME

HMS Dauntless was launched from BAE Systems' Govan shipyard in January 2007 and was handed over to the Royal Navy in December 2009. She is the second of the fleet of six Type 45 anti-air warfare destroyers that will provide the backbone of the UK's naval air defences for the next 30 years and beyond.

Queen Elizabeth Class carriers

BAE Systems is a member of the Aircraft Carrier Alliance, responsible for delivering the biggest and most powerful surface warships ever constructed in the UK. The two carriers will sustain thousands of skilled jobs across industry and will be a key component of the UK's maritime defence capability.

Sales¹ in 2009 were £6,298m (2008 £4,638m). Sales¹ growth was 36% largely due to the commencement of aircraft deliveries and support on the Saudi Typhoon programme, increased deliveries of the Typhoon Tranche 2 standard, and a full year of Detica sales.

Underlying EBITA² was £670m (2008 £491m) with return on sales maintained at 10.6%.

Operating cash inflow³ was £285m (2008 £651m) reflecting the utilisation of programme advance funding.

Order intake¹ increased by £4.6bn to £8,789m (2008 £4,195m), giving a closing order book¹ of £24.3bn.

Military Air Solutions

In 2009, the business secured contracts totalling almost £3bn for availability support on the Typhoon and Harrier aircraft fleets, and the Typhoon Tranche 3A production contract for 88 aircraft.

Delivery of Typhoon aircraft to the four partner nations and Austria continues with 208 aircraft delivered, 50 being Tranche 2 standard aircraft. The first eight of 72 Typhoons were delivered to the Royal Saudi Air Force. Upgrade work on the Tranche 1 aircraft continues to provide the UK Royal Air Force (RAF) with increased operational capability.

In March, the UK government awarded the business a £430m five-year Typhoon Availability Service (TAS) contract to work with the RAF to ensure aircraft are available to meet operational commitments. In September, the Typhoon Support Centre and Maintenance Facility were officially opened at RAF Coningsby, marking the official start of our TAS undertaking.

A five-year contract worth in excess of £400m to provide a support service for the Radar and Defensive Aids Sub-System (DASS) for the Typhoon fleets of the air forces of the UK, Germany, Italy and Spain was awarded in October.

On the Tornado and Harrier programmes, operational requirements continued to be met through both the delivery of contractual milestones and Urgent Operational Requirements to support aircraft in theatre.

Typhoon Tranche 3A contract award

The production contract for 88 Tranche 3A Typhoon aircraft demonstrates a strong, long term commitment by the UK Ministry of Defence to the Typhoon programme. It will sustain many highly skilled jobs across UK industry and provide the country with outstanding defence capabilities for years to come.

The UK Ministry of Defence (MoD) also awarded the Harrier Platform Availability Contract worth in excess of £550m to support the UK's Joint Force Harrier Fleet until their planned out of service date.

During the year, six Gripen aircraft were accepted by the South African customer. Hawk aircraft deliveries for South Africa are now complete and the programme is in the support phase.

Aircraft acceptances of the Hawk Mk128 Advanced Jet Trainer for the RAF are progressing, with 17 of 28 now accepted. Activity under the Hawk Integrated Operational Support programme continues, with aircraft availability consistently in excess of the 95% target.

Support continues to Hindustan Aeronautics Limited of India to conclude negotiations on the requirement for a further 57 Hawks in India.

The first production Nimrod MRA4 made a successful maiden flight from Woodford in September. Formal customer acceptance is anticipated in early 2010.

On F-35 Lightning II, major airframe units and systems for all three aircraft variants under development and initial production contracts have been delivered. The first F-35 airframes are in the UK for structural testing and the UK government has committed to order three of the Short Take Off and Vertical Landing (STOVL) aircraft for operational test and evaluation.

BAE Systems continues to leverage its expertise and capabilities in Unmanned Aircraft Systems and position itself in this growth market with Mantis making its first flight in October. Good progress is being made on Herti, with ongoing flight trials of the production standard variant. Final assembly of the Taranis advanced technology demonstrator is underway.

In September, consultations started on a programme of approximately 1,100 potential job losses across UK sites at Woodford, Samlesbury, Warton and Farnborough.

Following the publication of the independent report by Charles Haddon-Cave QC into the loss of Nimrod XV230 over Afghanistan in 2006, BAE Systems has appointed Dr Chris Elliott FREng, a leading systems

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 the Financial review on page 30)

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

New buildings keep the environment in mind

Additions to our site at Samlesbury are being designed and built to meet demanding environmental criteria, and to reduce environmental impacts and running costs. The low-energy buildings make maximum use of daylight whilst minimising solar gain and incorporate innovative design through the use of night time cooling and natural ventilation to reduce the need for air-conditioning. Designed also with energy efficient heating systems, including a biomass boiler, and leading edge lighting controls, these features in combination ensure that we meet a requirement that 10% of the energy needs of the new developments are provided from renewable sources. The site also has a small-scale wind turbine that supplies the new site entrance building.

engineer and barrister, to support and advise Nigel Whitehead FREng, Group Managing Director, Programmes & Support, who will undertake a review of the Group's approach to product safety across all its sectors in the UK.

BAE Systems Surface Ships

In October, the Group acquired VT Group plc's 45% shareholding in BVT Surface Fleet Limited. The wholly-owned subsidiary has been re-named BAE Systems Surface Ships Limited.

In July 2009, the business signed a 15-year Terms of Business Agreement with the UK MoD, providing a minimum of 15 years exclusivity for the design, build and integration on specified MoD shipbuilding programmes, including the Future Surface Combatant. It also gives a contractual guarantee to deliver a minimum of £350m of financial benefits to the MoD over the duration of the contract.

On the Type 45 programme, the second ship, Dauntless, was accepted off contract in Portsmouth in December. The third ship, Diamond, has completed her first sea trials and the fifth ship, Defender, was launched in October. In September, a multi-year contract for over £300m was signed for the in-service support of the six Type 45 destroyers.

Under the Queen Elizabeth Class aircraft carriers programme, a revised build strategy was announced in March under which BAE Systems, as part of the Aircraft Carrier Alliance, will deliver substantial sections from the Clyde and Portsmouth shipyards, as well as managing the integration of the ships at Rosyth. First steel was cut in July, engineering works to facilitate the delivery of the blocks from the Govan yard have been completed and substantial progress has been made in fabrication of units for the first ship, HMS Queen Elizabeth.

On export programmes, the first Oman vessel was launched in June, and the first and second ships for Trinidad & Tobago were launched in August and November, respectively.

Surface Ships continues to support the Royal Navy as its long-term partner in the management of Portsmouth Naval Base.

Submarine Solutions

The first of class Astute submarine successfully completed its nuclear power plant testing programme and has commenced sea trials. This is the first time since the Vanguard Class boats were successfully accepted in 1999 that a new to service submarine has undertaken sea trials in the UK. Ambush, the second Astute boat, is scheduled for launch at the end of 2010.

Involvement in the concept phase for the successor to the Vanguard Class submarine has been extended into 2010 in support of requirements definition.

Detica

Detica has continued to focus on helping its clients to collect, manage and exploit information to reveal actionable information intelligence. Detica is now developing a range of new, innovative technologies for analytical decision support, real-time situational awareness and control, and secure computing and communications. Detica is investing in combining these technologies with its in-depth security and industry knowledge to create differentiated solutions to tackle management of personnel security, defending against chemical, biological, radiological, and nuclear threats and protecting deployed forces.

In the UK market, Detica is repositioning as a solution integrator, combining its core consultancy, specialist products and applications development capabilities to deliver larger-scale systems integration and managed services programmes across both government and commercial markets. A system using Detica NetReveal® has helped Her Majesty's Revenue and Customs to identify and target tax evasion using advanced data analytics. Detica was part of a consortium selected by the Highways Agency to provide consultancy services to the National Road Telecommunications System, as part of a ten-year, £20m programme.

Detica is helping to build international opportunities in the three global security mission areas of cybersecurity, border and transportation security, and counter terrorism and organised crime. The Detica NetReveal® solution also continues to show strong global sales growth, with significant wins during the year. Also during the year, the Reveal suite of software-based solutions has been extended to include TxtReveal™, for analysing large volumes of unstructured data.

Integrated System Technologies (Insyte)

In July, the Seawolf Mid-Life Update system was declared 'In Service' on the Type 23 frigates whilst the update programme continues on the first of class Type 22 frigate.

In November, the FALCON mobile battlefield communication system for the UK Army and RAF passed its Equipment Acceptance Trial.

During the year, the 500th Sting Ray lightweight torpedo was delivered to the UK MoD. A £99m export contract for the Norwegian Navy was secured. In July, the UK MoD placed a ten-year, £370m Torpedo Capability Contract.

Both of the contracted Type 102 Commander air defence radars have now been accepted by the UK MoD and the first system deployed at its operational base.

A revised delivery schedule has been agreed with the UK MoD on the ARTISAN 3D Medium-Range Radar naval programme.

Milestones on the Maritime Composite Training System for use at HMS Collingwood are not being achieved on schedule. A review of the remaining programme is being undertaken to agree a revised delivery schedule.

Following a review of forward workload, the business announced a redundancy programme in November involving a loss of up to 642 jobs.

INTERNATIONAL

FINANCIAL HIGHLIGHTS

- Like-for-like sales¹ growth of 15% over 2008
- Good operating cash flow³ performance

PERFORMANCE

	2009	2008	2007
Sales ¹	£4,253m	£3,333m	£3,359m
Underlying EBITA ²	£442m	£435m	£435m
Return on sales	10.4%	13.1%	13.0%
Cash inflow ³	£816m	£163m	£678m
Order intake ¹	£4,825m	£4,065m	£3,876m
Order book ¹	£11.6bn	£11.0bn	£7.9bn

Guy Gniffiths Group Managing Director, International

The International operating group, with 19,700 employees¹, comprises the Group's businesses in Saudi Arabia and Australia, together with a 37.5% interest in the pan-European MBDA joint venture, a 20.5% shareholding in Saab of Sweden and a 49% shareholding in Air Astana.

KEY POINTS

- Entry into service of Typhoon aircraft under the Salam programme
- Order intake¹ secured for three-year support to Typhoon aircraft for the Kingdom of Saudi Arabia
- Order award for Australian Air Warfare Destroyer build programme
- Delivery of four inshore patrol vessels to New Zealand MoD

LOOKING FORWARD

The Group seeks to sustain its long term presence in the Kingdom of Saudi Arabia through delivering on current programmes and industrialisation commitments, and developing new business, including in the land sector.

In Australia, the Defence White Paper and 2009-10 Budget included a commitment to increased defence funding for the next decade by approximately 3% per annum and a Strategic Reform Programme that will place cross-service pressure on support budgets. BAE Systems is well placed to benefit from both new defence procurement and increased Readiness & Sustainment activities.

SALES¹ BREAKDOWN

ORGANIC SALES¹ GROWTH

15%

Like-for-like sales¹ growth

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 the Financial review on page 30)
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust.

TYPHOON FOR THE ROYAL SAUDI AIR FORCE (RSAF)

The RSAF has commenced flying operations following the delivery of the first eight of 72 Typhoon aircraft. To support this, the governments of the Kingdom of Saudi Arabia and the United Kingdom reached agreement on detailed arrangements that will provide support for operations by the RSAF Typhoon fleet for an initial three-year period.

Australia contract wins

BAE Systems Australia has secured a contract worth A\$309m (£172m) under the Royal Australian Navy's Air Warfare Destroyers (AWD) programme to construct 12 hull modules for each of the three destroyers. The business has secured a A\$45m (£25m) contract to install five new integrated satellite communications terminals on board the AWD and Landing Helicopter Dock vessels. Two contracts with a combined value likely to be in excess of A\$420m (£234m) to carry out deeper maintenance on the Australian Seahawk and Black Hawk helicopters have also been secured.

During 2009, International achieved sales¹ of £4,253m (2008 £3,333m). The increase in sales¹ was predominantly a result of a full 12 months of trading from the acquired Tenix Defence business and entry into service of Typhoon aircraft in the Kingdom of Saudi Arabia.

Underlying EBITA² was £442m (2008 £435m) generating a return on sales of 10.4% (2008 13.1%). The reduction in return on sales is due to the low margin traded in the early stages of the Salam programme and the acquired Tenix Defence business being at lower margins than the average of this operating group.

Operating cash inflow³ was £816m (2008 £163m).

CS&S International

BAE Systems has a major presence in the Kingdom of Saudi Arabia (KSA). It acts as prime contractor for the UK/KSA government-to-government defence agreement. It also holds certain direct contracts with the Saudi government. Progress is ongoing to modernise the Saudi armed forces in line with the Understanding Document signed in December 2005 between the UK and KSA governments.

Around 4,900 people are employed by the Group in the Kingdom of Saudi Arabia, of whom approximately half are Saudi nationals. The business continues to develop its presence in Saudi Arabia and remains committed to developing a greater indigenous capability in the Kingdom. This is being enhanced by the entry into service of the Typhoon aircraft and the subsequent development of the Typhoon industrial base in Saudi Arabia.

Of the 72 Typhoon aircraft contracted in 2007 under the Salam programme, eight were delivered in the year to the customer in line with programme. The initial support solution contract was also agreed and flying operations commenced.

The business continues to support the operational capability of both the Royal Saudi Air Force and Royal Saudi Naval Forces. Significant incremental orders totalling £1.2bn were received in the period for the Tornado Sustainment Programme (TSP) weapons contract, Naval Minehunter Mid-Life Update and a multi-year Naval Training Programme.

The C4I⁴ programme remains challenging and discussions continue with the aim of agreeing the definition of a solution that meets the customer requirement.

The first Tactical land vehicles were delivered to the Saudi Arabia National Guard in June and deliveries have continued through the second half of the year. A contract for the support of Tactical land vehicles has been secured. Further opportunities are being pursued in support of the Royal Saudi Land Force's programme of capability enhancements and equipment upgrades.

Australia

The Australian Government's Strategic Reform Programme plans A\$20bn (£10bn) in internal savings over the next decade through the delivery of significant efficiencies. The business is engaged with the Australian government and Australian Defence Force (ADF) in developing plans and creating opportunities to deliver these efficiencies.

Significant contract awards in 2009 included a A\$94m (£52m) contract to enhance and support the ground segment of the ADF's satellite communications capability, contracts potentially worth up to A\$570m (£318m) to provide maintenance and upgrades for the Royal Australian Navy's Seahawk and Australian Army's Black Hawk helicopter fleets and Royal Australian Air Force's F/A-18 Hornet fighter aircraft, and a A\$309m (£172m) contract to build 36 hull modules for the Royal Australian Navy's three new Air Warfare Destroyers.

In the year, four inshore patrol vessels were delivered to the New Zealand MoD and two offshore patrol vessels are expected to be delivered in the first quarter of 2010. Warranty claims relating to the supply of the multi-role vessel in 2007 that were subject to mediation have been satisfactorily resolved.

The business is a subcontractor to Boeing on the Wedgetail Airborne Early Warning and Control programme. In the year, the business delivered the majority of the ground subsystem and the air subsystem entered the final acceptance testing phase. The business is working to deliver the Electronic Warfare systems in support of the aircraft integration programme.

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 the Financial review on page 30)

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 Command, Control, Communications, Computers and Intelligence

Joint venture agreement with Mahindra & Mahindra

In November, BAE Systems and Mahindra & Mahindra signed an agreement to create a land systems, joint venture defence company, based in India. The skills and knowledge of the two companies are an excellent fit, and the values and vision which we share will allow this venture to prosper and innovate. India was made the Group's seventh home market during the year.

The Australian government has issued a revised request for the supply of medium and heavy tactical trucks under its Land 121 programme. The Australian business is partnered with BAE Systems Land & Armaments and Scania, and participated in the vehicle trial and evaluation component of the programme. The results of this component, which will be known in the first half of 2010, will be used to down-select two preferred tenderers with contract award expected in 2011.

The programme to supply two Landing Helicopter Dock ships to the Royal Australian Navy is progressing with numerous milestones achieved, including the laying of the keel for the first ship, and the successful completion of the Whole of Ship Detailed Design Review.

The completion accounting process continues with the former owners of the Tenix Defence business in Australia and an expert has been appointed to determine certain matters in dispute.

MBDA (37.5% interest)

MBDA's performance in 2009 delivered an increasing return on sales on broadly unchanged sales volumes.

Order intake in 2009 was strong and included Scalp Naval production in France, a second year contract extension for the UK Complex Weapons programme, and in export markets, Marte anti-ship missiles to the United Arab Emirates, ground-based vertical launch Mica air defence weapons to a Middle Eastern country, Storm Shadow stand-off missiles, and Exocet anti-ship missiles.

Key domestic deliveries included Mica air-to-air missiles, Taurus stand-off missiles and Seawolf naval air defence missiles. Export deliveries included Aster and Mistral surface-to-air missiles, Storm Shadow stand-off missiles and Exocet anti-ship missiles.

Development programmes continue to progress well, with key milestones being passed on the MEADS air-defence programme, Meteor air-to-air missile programme, all Assessment Phases of UK Complex Weapon Programmes and Scalp Naval stand-off missile programme.

Significant evidence has been gathered out of Sea Viper firing campaigns during the year to support the overall system qualification, but an

Employees aid emergency communications in fire ravaged Victoria

In 2009, the Australian state of Victoria experienced the worst and deadliest forest fires on record. Employees at a communications facility in rural Victoria found themselves at the centre of response efforts. They worked closely with emergency services to supply and maintain lifesaving radio communications used to coordinate response efforts with fire crews. Employees provided support, configuring and maintaining trailer mounted mobile radio stations used to boost signals between distant emergency teams. The Group donated A\$200,000 while our employees raised an additional A\$96,000 for the Australian Red Cross to help those in need.

investigation is currently underway to identify the cause of issues arising during these campaigns as well as establishing a revised plan to support the Type 45 programme.

Saab (20.5% shareholding)

Saab's sales were SEK24.6bn (£2.1bn). Operating income was SEK1.4bn (£115m) producing an operating margin of 5.6%, compared with 0.7% in 2008.

Key orders won during 2009 include a SEK700m (£61m) order within the civil security area, Gripen orders from the Swedish Defence Materiel Administration (FMV) of approximately SEK1bn (£87m) to support operational capacity and future capability studies and a SEK1.5bn (£130m) order from the United Arab Emirates for an airborne surveillance system.

In response to market conditions, Saab announced 670 redundancies across its Dynamics and Commercial Aircraft areas of business during the year.

Defence Land Systems India Private Limited (26% shareholding)

As a further step in our strategy of developing India as a home market, the business entered into a joint venture arrangement with Mahindra & Mahindra Limited to create a new land systems-focused joint venture defence company based in India. The joint venture is expected to be established in the first half of 2010.

HQ & OTHER BUSINESSES

HQ & Other Businesses, with 2,200 employees¹, comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management

FINANCIAL HIGHLIGHTS

- Settlement with final insurer achieved, enabling closure of the Group's Financial Risk Insurance Programme
- Regional Aircraft profits of £46m following placement of 44 aircraft and settlement of outstanding commercial items
- Underlying EBITA² excludes regulatory penalties of £278m

PERFORMANCE

	2009	2008	2007
Sales ¹	£254m	£235m	£243m
Underlying EBITA ²	£(71)m	£(101)m	£(203)m
Cash (outflow)/inflow ³	£(366)m	£(66)m	£181m
Order intake ¹	£175m	£212m	£345m
Order book ¹	£0.4bn	£0.4bn	£0.4bn

LOOKING FORWARD

Market conditions for the commercial aircraft market continue to provide a challenging trading environment due to the impact of the global economic downturn and tightened availability of funding to operators

In 2009, HQ & Other Businesses reported a loss² of £71m (2008 loss² £101m) on sales¹ of £254m (2008 £235m)

In 2008, impairment charges of £32m were taken in respect of the spares and support business, and aircraft carrying values within Regional Aircraft

In 2009, the Regional Aircraft business has recognised underlying EBITA² of £46m following favourable settlement of some outstanding commercial items, together with profits on sale of aircraft and lease extension activity

A charge was taken in 2009 for a long-standing commercial dispute on an overseas defence equipment contract

Operating cash outflow³ in 2009 was £366m (2008 £66m). This includes additional contributions in respect of UK pension schemes totalling £310m (2008 £104m)

The commercial aircraft market continues to prove challenging in the global economic downturn. Lease and sale discussions with operators are ongoing with regard to current and future fleet requirements, and marketing activity is focused on both uncontracted idle aircraft and those returning off lease

Whilst support revenues have reduced due to lower demand for aircraft components, this has been partially offset by increased revenues from engineering and technical support services

Whilst market conditions have impacted the general level of financing available to airlines globally, the portfolio customer base remains relatively robust and the business continues to closely monitor operator performance against default risk

The balance sheet carrying value of aircraft in the Regional Aircraft business (£189m) is based on the net present value of forecast future net leasing or disposal income

In the year, a settlement with the remaining insurer under the Group's Financial Risk Insurance Programme was completed

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 the Financial review on page 30)

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

UK SPORT PARTNERSHIP

Launched in January 2008, BAE Systems' five-year partnership with UK Sport is helping British athletes in their quest for success at major sporting championships including World Championships, and Commonwealth, Olympic and Paralympic Games. The partnership is managed by the Group's Advanced Technology Centre and provides engineering support and state-of-the-art technologies to sports ranging from cycling to bob-skeleton. Our ongoing partnership offers us an ideal opportunity to showcase the importance of engineering.

5. Governance

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

Board of directors	76
Corporate governance	78
Remuneration report	90
Other statutory and regulatory information, including statement of directors' responsibilities	112

CV90

The CV90, an agile, multi-role combat vehicle with all-target capabilities, is in service with the armies in the Netherlands, Sweden, Norway, Denmark, Switzerland and Finland, and has been deployed with UN and NATO operations abroad. In 2009, BAE Systems delivered the 1,000th CV90 Infantry Fighting Vehicle, marking a milestone for a vehicle that has been in production since 1991.

BOARD OF DIRECTORS

CHAIRMAN

1. Dick Oliver FREng

EXECUTIVE DIRECTORS

2 Ian King

3. Linda Hudson

4 George Rose

NON-EXECUTIVE DIRECTORS

5. Paul Anderson

6 Phil Carroll

7 Michael Hartnall

8 Andy Inglis

9 Sir Peter Mason KBE

10 Roberto Quarta

11 Nick Rose

12. Carl Symon

13 Ravi Uppal

1. Dick Oliver FREng^{3,4}

Chairman

Dick Oliver was appointed as Chairman in 2004. A civil engineer, Dick Oliver joined BP in 1973 where he held a variety of senior positions culminating in his appointment to the board of BP plc as CEO of Exploration and Production in 1998. He was subsequently appointed deputy group chief executive of BP in 2003, stepping down from that position when he assumed the chairmanship of BAE Systems. Dick Oliver chairs the Board's Nominations Committee and the Non-Executive Directors' Fees Committee. He is a Business Ambassador for UK Trade & Investment, a Fellow of the Royal Academy of Engineering, and Chair of the Education for Engineering (E4E) Policy Group. He is a member of the Business Council for Britain and the Trilateral Commission. He is a former non-executive director of Thomson Reuters plc. Appointed 2004 Age 63

2. Ian King⁴

Chief Executive

Ian King was appointed as Chief Executive on 1 September 2008, having originally been appointed to the Board as Chief Operating Officer, UK and Rest of the World, at the beginning of 2007. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Immediately prior to the BAE/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems. He is a non-executive director of Rotork plc. Appointed 2007 Age 53

3. Linda Hudson⁴

Chief Operating Officer, President and CEO, BAE Systems, Inc.

Linda Hudson was appointed to the Board on 26 October 2009 as Chief Operating Officer, and is also President and CEO of BAE Systems, Inc. She was previously President of the Company's US-based Land & Armaments operating group. She joined the Company at the end of 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. She serves on the USO 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. Appointed 2009 Age 59

4. George Rose

Group Finance Director

George Rose was appointed Group Finance Director in 1998. Prior to joining the Company in 1992, he held senior positions in the Rover Group and Leyland DAF. He is a non-executive director of Saab AB and National Grid plc, and a member of the Industrial Development Advisory Board. He is a Fellow of the Chartered Institute of Management Accountants. Appointed 1998 Age 57

5. Paul Anderson²

Appointed to the Board on 8 October 2009, Paul Anderson retired as Chairman of Spectra Energy Corporation in May 2009 where he remains a non-executive director. 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. In the intervening period he served as managing director and chief executive officer of BHP and, subsequently, of the newly merged BHP Billiton. He is a non-executive director of BP plc and a former non-executive director of BHP Billiton plc and Qantas Airways Limited. Appointed 2009 Age 64

6. Phil Carroll³

Phil Carroll is a former chairman and chief executive of Fluor Corporation, and a former president and chief executive of Shell Oil Company Inc. He was appointed by the US Department of Defense in 2003 to serve as the first Senior Adviser to the Iraqi Ministry of Oil. He is a former non-executive director of Scottish Power plc. Appointed 2005 Age 72

7. Michael Hartnall¹

Michael Hartnall is a former finance director of Rexam plc, prior to which he held senior positions with a number of manufacturing companies. He is a non-executive director of Lonmin plc and a former non-executive director of Elementis plc. Michael Hartnall chairs the Board's Audit Committee. He is a Fellow of the Institute of Chartered Accountants in England and Wales. Appointed 2003 Age 67

8. Andy Inglis²

Andy Inglis is a director of BP plc. He is a member of the BP executive management team, and is also chief executive of BP's Exploration & Production business. He is a Fellow of the Royal Academy of Engineering and a Fellow of the Institute of Mechanical Engineers. Andy Inglis chairs the Board's Corporate Responsibility Committee. Appointed 2007 Age 50

9. Sir Peter Mason KBE^{1,2,3}

Sir Peter Mason is chairman of Thames Water and chairman of Acergy S.A. He was formerly chief executive of AMEC plc, executive director of BICC plc, chairman and chief executive of Balfour Beatty Limited, and chief executive of Norwest Holst Group PLC. Sir Peter has been appointed to the Board's Senior Independent Director. Appointed 2003 Age 63

10. Roberto Quarta^{1,5}

Roberto Quarta is a partner in the private equity firm Clayton, Dubilier & Rice, in connection with which he serves as chairman of Rexel SA and Italtel. He was previously chairman and chief executive of BBA Group plc, an executive director of BTR plc, and a non-executive director of PowerGen plc and Equant NV. Appointed 2005 Age 60

11. Nick Rose^{1,5}

Appointed to the Board on 8 February 2010, Nick Rose has held the appointment of Chief Financial Officer of Diageo plc since 1999 where, in addition to his finance responsibilities, he is also responsible for supply, procurement, strategy and IT on a global basis. He has served in a number of finance roles since joining Diageo's predecessor company, Grand Metropolitan, in 1992, including group treasurer and group controller. Prior to that he spent 11 years with Ford Finance. He is a former non-executive director of Moët Hennessy SNC and Scottish Power plc. Appointed 2010 Age 52

12. Carl Symon⁵

Carl Symon retired from IBM in 2001 having held a number of senior positions in the US, Europe, Latin America and Asia, including serving as chairman and chief executive of IBM UK Limited. He is a non-executive director of BT Group plc and Rexam PLC, and a former non-executive director of Rolls-Royce Group plc and former chairman of HMV Group plc. Carl Symon chairs the Board's Remuneration Committee. Appointed 2008 Age 63

13. Ravi Uppal¹

Ravi Uppal is managing director and chief executive officer of L&T Power Limited, a member of the Larsen & Toubro group which operates in the technical, engineering, construction and manufacturing sector, and is one of the largest companies in India's private 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. Prior to that he was managing director of Volvo India, establishing that corporation's business in India. Appointed 2008 Age 57

Each of the nine non-executive directors listed above is considered to be independent for the purposes of the Combined Code on Corporate Governance

COMPANY SECRETARY

David Parkes

- 1 Member of the Audit Committee
- 2 Member of the Corporate Responsibility Committee
- 3 Member of the Nominations Committee
- 4 Member of the Non-Executive Directors' Fees Committee
- 5 Member of the Remuneration Committee

CORPORATE GOVERNANCE

“A robust governance structure underpins the delivery of the Group’s strategy.”

Dick Oliver Chairman

In last year's report and accounts I made reference to the crisis in financial markets and how this had caused directors to reflect on their governance responsibilities. The ramifications of the financial crisis have been wide reaching with many reflecting on possible corporate governance failures and, towards the end of 2009, Sir David Walker published his review of corporate governance in UK banks. His review is a thorough analysis of corporate governance that, in many areas, is applicable beyond the banking and finance industry. This was recognised by the Financial Reporting Council (FRC), which worked closely with Sir David and issued its own report on proposed changes to the Combined Code, the UK's corporate governance code. There is never room for complacency, and for me the most important message from both reports is that collectively and individually we can, and need to, learn from experience and continue to improve the way we run companies. We are taking time in the first half of this year to carefully consider the detail in the two reports and agree what we need to do to continue to move our own governance processes forward.

The FRC report proposes that greater emphasis should be placed on the principles in the Code, and recommends adopting certain new principles and adding to existing ones. I wholeheartedly agree with this. The effective working of a board is far too dynamic and complex to be appreciated and understood through the application of 'tick-box' provisions. Focused and insightful reporting on the Code's principles is an essential element of the UK's governance model and for a number of years in these corporate governance reports I have tried to provide shareholders with a meaningful insight into corporate governance practices in BAE Systems based on these principles. Sitting as it does within our report and accounts, this report is an important statement on the governance of the Company and forms part of our wider engagement with shareholders. There are

a number of aspects to this engagement ranging from the formal voting on the resolutions we put to the Annual General Meeting (AGM) to more informal aspects such as the contact I look to maintain with key shareholders to assist them in the stewardship of their investments.

Shareholder voting on the continued appointment of a company's directors is a powerful asset that underwrites the relationship between board and shareholders. After careful analysis and consultation Sir David Walker came down in favour of recommending that chairmen should stand for annual shareholder re-election. Without doubt, the role of the board chairman has developed a good deal since Sir Adrian Cadbury wrote his far reaching report on corporate governance in 1992. The position has become more clearly defined and is uniquely placed at the centre of a company's governance arrangements. I am in agreement with Sir David's analysis and will personally stand for annual shareholder re-election with effect from this year's AGM.

Board effectiveness

One of the recommendations in the Walker Report and the FRC's report relates to the evaluation of board performance and the use of an external facilitator to undertake this. We have used an external facilitator to assist with our annual evaluation process for the last four years, and this has helped to contribute to the effectiveness of the Board and its committees. I see it as providing the directors with a tool that helps us analyse our performance and agree what we need to do to continue to improve. For me as Chairman, it provides a useful and constructive means by which issues can be raised in a timely manner and dealt with as part of the normal governance processes of the Board. Through the evaluation process we regularly review how we operate as a board, looking at areas such as

People – How effective is the Chairman? Do we have the right mix of executive and non-executive directors around the board table? Are our succession planning processes effective in ensuring that we have non-executives with the right skills, knowledge and experience? How well do we know the senior executives below board level and do we have robust succession plans for the executive director positions?

Information and Board processes – What do we need to do to ensure that all directors develop a good understanding of the business? Are directors receiving the information they require to make timely and appropriate decisions? Do we manage directors' induction and training effectively? What do we need to do to ensure that we get maximum value from the finite amount of time directors have together? Are key issues understood, discussed and agreed upon and concerns appropriately addressed? Does the board have the right key performance indicators with which to monitor performance?

Behaviour – How effective are we at making decisions? Do board members display appropriate behaviours that allow important matters to be raised and openly discussed? Are all board members positively engaged in decision making? Accepting that the chairman and chief executive are key players in the board room, is their relationship effective, both in relation to each other and the board as a whole?

For the last five years our annual board effectiveness evaluations have been undertaken by Sheena Crane, an experienced consultant, whose only interest with BAE Systems is her work with the Board. 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 how 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 derives from this. With regards to information on personal performance, I meet with each director and provide feedback on a one-to-one basis, committee chairmen also get feedback on committee performance. Importantly, feedback on my performance in chairing the Board is provided by the consultant directly to our Senior Independent Director, who discusses this with the other non-executive directors before I meet with him to receive feedback.

The Combined Code requires that a board be supplied with information in a timely manner in a form and quality appropriate to enable it to discharge its duties. Describing how we apply this principle demonstrates the value of performance evaluation in helping to develop directors' information requirements. Last year in the Board's objectives for 2009 we reported that periodically we wished to take a more in-depth look at specific programmes, which we believed would help directors to develop a deeper understanding of the Key Performance Indicator (KPI) information they receive on a regular basis. In 2009 the Board undertook a number of what we term 'deep dives' in different areas of our business. For example, one looked at the F-35 aircraft programme, which was done as part of a visit to the UK production facility for this programme, allowing directors to engage directly with members of the project team.

Recognising the important role the Board plays in ultimately agreeing the strategic direction the Company takes, we have also used the evaluation process to refine how the Board is engaged in the review of strategy. For example, following on from last year's evaluation we modified the strategy review process and added an additional mid-year strategy workshop to engage the Board more fully in our Integrated Business Planning process.

For the last four years we have provided details on 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. In the table below we report on the evaluation we have just completed.

BOARD PERFORMANCE – 2009 OBJECTIVES AND ACHIEVEMENTS

2009 objectives

- Maximise the effectiveness of the strategy planning process and continue to visit operational sites to develop further the Board's awareness and understanding of the Group
- Continue to engage with management in studying and developing the actions needed to exploit global markets
- Support the Chief Executive in ensuring the Woolf Report recommendations are implemented across the Group, ensuring all staff and external stakeholders are engaged
- Provide support to the new Chief Executive to ensure his success
- Focus on KPIs, ensuring they continue to provide the right level of performance oversight, and periodically take a more in-depth look at specific programmes
- Ensure attention remains focused on near-term and long-term succession planning for the Board

2009 achievements

- The Board held an additional mid year strategy review to consider the initial output from the Group's strategy and business planning process. Also, board meetings were held at Company sites in the UK and US to provide directors with an opportunity to develop further their understanding of the Group
- The development of global markets was addressed through the Company's strategy and business planning process, in which the Board was engaged on a regular basis. In addition, the Chief Executive led the Executive Committee in developing management development processes aimed at increasing global management mobility. The Nominations Committee reviewed progress on this during the year
- As reported elsewhere in this report, good progress has been made in implementing the Woolf Committee Report recommendations. Throughout the year, the Chief Executive updated the Board and Corporate Responsibility Committee on progress. Board members participated in an externally facilitated ethics training and awareness session aligned to the training undertaken by employees as part of the Code of Conduct implementation programme
- Where possible, the Board members have looked to assist Ian King in his first full year as Chief Executive
- Throughout 2009, the Board reviewed KPIs on a regular basis. In addition, it undertook a number of 'deep dives' into particular parts of the business to help develop a greater appreciation of the underlying businesses and the practical application of performance management
- The Nominations Committee undertook a review of the Board succession priorities for the next three years. This helped to guide non-executive director search activities undertaken in 2009 and has helped set future priorities

BOARD PERFORMANCE – 2010 OBJECTIVES

- Maintain focus on developing the Company's strategy and make progress in achieving the Strategic Actions agreed by the Board in 2009
- The Board and the Corporate Responsibility Committee to continue to monitor the development of a Total Performance culture, including implementation of the Woolf Committee's recommendations
- Focus on monitoring operational performance, including cost and efficiency metrics
- Continue to monitor the development of the competencies and culture required to support the growth of our home markets
- The Chairman to facilitate continuing development for the non-executive directors, including their understanding and familiarity with the Company's businesses, core processes and markets

Board and Group governance

At present, the BAE Systems Board comprises three executive directors, nine non-executives (all independent) and myself as Chairman. Balance is a key requirement when it comes to the composition of a board, not only in terms of executives and non-executives but also with regards to the mix of skills, experience and knowledge. Having a number of executives on the Board, and also providing non-executives with regular access to executives below the Board, helps to ensure that views and perceptions are not dominated by a single executive voice. The Chief Executive, Group Finance Director and Chief Operating Officer (who has specific responsibility for our US business) are all Board members. In addition, other senior executives attend parts of Board meetings on a regular basis primarily to provide the non-executive Board members with a wider and more immediate view of operational issues affecting

the Company – and it also helps with succession planning. Throughout the year senior operational and functional executives attended board meetings, and on two occasions the Board and Executive Committee participated in informal strategy review sessions.

In our governance framework, the responsibilities of the Chairman and the Chief Executive are separate, distinct and complementary. In this we adhere to the principle in the Combined Code requiring a clear division of responsibilities at the head of the company. Essentially, as Chairman I am responsible for the effective working of the Board, whilst the Chief Executive is responsible for the leadership and the operational performance of the Company. The extract from our Board Charter below details the specific responsibilities of these two roles.

ROLES OF THE CHAIRMAN AND CHIEF EXECUTIVE

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 Combined Code on Corporate Governance 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
- Leading the evaluation of the performance of the Board, its committees and individual directors
- Establishing an effective working relationship with the Chief Executive, providing support and advice whilst respecting executive responsibility
- Ensuring that a well constructed induction programme is provided for new directors, that all directors have the opportunity to develop their understanding of the Company and that they are kept informed of matters affecting the Company

The role of the Chief Executive

The Chief Executive is responsible for the leadership and the operational and performance management of the Company within the strategy and business plan agreed by the Board.

The Chief Executive is specifically responsible for the following in respect of his/her relationship with the Board:

- Developing a business strategy for the Company to be approved by the Board on an annual basis
- Producing business plans for the Company to be approved by the Board on an annual basis
- Overseeing the management of the executive resource and succession planning processes and presenting annually the output from these to the Board and Nominations Committee
- Ensuring that effective business and financial controls and risk management processes are in place across the Company and that all relevant laws and regulations are complied with
- Making recommendations to the Board on the appropriate delegation of authority within the Group
- Keeping the Board informed regularly as to the performance of the Company and bringing promptly to the Board's attention all matters that materially affect, or are capable of materially affecting, the performance of the Company and the achievement of its strategy
- Developing for the Board's approval appropriate values and standards to guide all activities undertaken by the Company
- Providing clear and visible leadership in responsible 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

As reported elsewhere in these reports, during 2009 the Company completed the initial phase of the implementation of the recommendations in the Woolf Report. An analysis of this activity is a good illustration of the different roles of the Board and the executive within our governance framework. The Board appointed Lord Woolf to lead an independent expert committee looking at the Company's ethical policies and processes. On receipt of the report the Board asked the Chief Executive to implement the recommendations and embed them into the Company's activities. In considering how to achieve this, the Chief Executive spent a good deal of time working with his senior executives to redefine the Group's values, and ensuring that our processes and procedures reflect these values and continue to provide us with a robust framework within which to deliver strategic and operational performance.

At a board meeting held in November last year, the Chief Executive presented his proposals on how he wished to take the Company forward, incorporating the recommendations in the Woolf Report into a coherent set of values, policies and processes. In addition, the Board agreed certain actions to ensure that it addressed the recommendations in the Woolf Report concerning the directors, the Board and its committees in particular. The changes agreed by the Board have been incorporated into updated versions of the following documents that form the basis of the Board's and the Group's governance framework:

Board Charter and Board Procedures Manual – the Charter sets out the Board's governance principles, matters reserved for the Board, and the specific responsibilities of the Chairman, Chief Executive and Senior Independent Director. The Manual details certain duties and rules governing the activities of directors, and also the processes and ways of work that have been adopted by the Board.

Operational Framework – this document is based on principles of good governance, and details the set of values, policies and processes that guide the work and behaviour of Group employees and also includes a clear system of delegated responsibilities.

The nature of the relationship between the Board and executive management is reflected in our governance framework. The Board Charter and Board Procedures Manual deal solely with the operation of the Board and how it discharges its responsibilities, parts of these documents reflect certain elements of the Company's Articles of Association and the provisions of the Combined Code. The Charter and Procedures Manual effectively only apply to the small group of individuals who sit on the Board, and it is the Operational Framework and the Code of Conduct that are the key documents for the Group as a whole, governing the activities of all its employees.

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. 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 is agreeing 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

We recognise that documenting a company's values, standards and processes comprehensively is just one element of an effective governance process. The essential requirement, and often the most demanding, is to ensure that it is embedded and operating effectively across a company's operations. 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 85).

Shareholder engagement

The AGM is a core element of our engagement with all shareholders and it would be wrong to think of it as little more than an event only involving those who are able to attend the meeting. It works in a number of different ways for different shareholders – whether they are large institutional investors or smaller retail investors, all have the opportunity to participate in this important element of the Company's governance.

BAE Systems has over 100,000 shareholders, the vast majority 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 the 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. I want the AGM to be a rewarding experience for attendees, and in recent years we have striven to achieve this by providing a video and a presentation on the Company's performance – in addition to the usual question and answer forum, and voting on the resolutions. Also, after the meeting shareholders have the opportunity to meet directors informally over lunch.

Succession planning

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 and these are described more fully in the following reports. However, the Board as a whole has a role to play in overseeing the development of management resources in the Group. As with any other resource, this has to be carefully managed with the aim of ensuring we have the individuals with the right skills to meet the needs of an increasingly complex and global business that is evolving all the time. Specifically, the Board wants to see depth and quality in the ranks of individual executives that one day will be candidates for appointment to board positions. Robust processes are in place to help us in this task and

progress is being made in developing the increasingly diverse management resource required to continue to deliver our strategy of being the premier global defence, security and aerospace company. We drew on these processes during the year in Linda Hudson's appointment to the Board as Chief Operating Officer, President and CEO of BAE Systems, Inc.

Our succession planning for non-executive directors is based on maintaining over time a complement of eight such directors. At times there will be slightly more or less as we recruit to fill actual or forthcoming vacancies, for example Paul Anderson joined the Board in October 2009 in anticipation of Phil Carroll's retirement in May 2010 and Nick Rose recently joined the Board following Sir Nigel Rudd's retirement at the end of the year. The Nominations Committee actively manages non-executive director succession based on anticipated retirement dates for existing directors and looks to initiate focused search activity well in advance of such dates. The membership of board committees is an important factor in succession planning, particularly with regards to the individuals who chair our Audit, Corporate Responsibility and Remuneration committees. I am pleased to report that, when we were recruiting last year, there were a number of excellent individuals available enabling us to select from high-quality candidate short-lists.

The BAE Systems Board has changed a good deal in recent years and our governance structure has evolved to keep pace with a complex and ever-changing company. We will continue to look to current and evolving best practice as a guide in meeting the governance expectations of our shareholders and the wider stakeholder community.

Dick Oliver Chairman

CORPORATE GOVERNANCE STATEMENT

Applying the principles of the Combined Code on Corporate Governance

The Board has structured its activities so as to incorporate the main and supporting principles in the UK's Combined Code, recognising these to be a sound statement of accepted good practice for a company such as BAE Systems. The core activities of the Board and its committees are documented and planned on an annual basis but this only forms the basic structure within which the Board operates. The directors are required to provide entrepreneurial leadership for the Company, relying on the business skills and judgement that each director possesses. The governance structure recognises this essential human element and the role of the Chairman in ensuring that decisions are made by the directors within a framework of prudent and effective controls.

The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that guide the activities of the Board and also details of the roles of the Chairman, Chief Executive and the Senior Independent Director. The governance principles reflect the main and supporting principles contained in the Combined 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 states that the Chief Executive is responsible for the leadership and operational management of the Company within the strategy and business plan agreed by the Board. Included within the Charter is a schedule of matters that have been reserved for the Board's decision. These include approving the vision, values, principles of ethical conduct, overall governance structure of the Company, and its strategy and business plans. Within the Board's delegated authorities it has reserved for itself, amongst other things, certain decisions concerning contract bids and tenders, acquisitions and disposals of businesses, capital expenditure and Company-funded product development expenditure.

A copy of the Board Charter can be found on the Company's website, or alternatively, can be obtained from the Company Secretary.

The Board

The Board comprises a non-executive chairman, nine non-executive directors and three executive directors.

The attendance by individual directors at meetings of the Board and its committees in 2009 is shown in the table opposite.

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.

Following appointment to the Board, directors undertake an induction programme aimed at familiarising them with the Company. The programme for directors joining during 2009 included the following:

- Directors' duties, corporate governance and board procedures,
- Business planning and internal control processes,
- Strategy and planning,

- Metrics used to monitor business performance,
- Investor relations,
- Corporate responsibility (including ethical business conduct, and health and safety), and
- Internal Audit

In addition to the above, as part of the induction process, new directors will typically visit the Group's principal operations in order to meet employees and gain an understanding of the Group's products and services. On-going training is provided for the Board and individual directors as required.

Mr Quarta is a partner in Clayton, Dubilier & Rice (CDR) and Mr Oliver 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 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 Oliver has no management responsibilities or oversight obligations in respect of CDR or any of its investments, and
- Mr Oliver has no involvement with the companies that Mr Quarta is a director of, or has management responsibility for, within CDR.

Mr Oliver 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.

In 2009, the Board was scheduled to meet eight times and in addition one day was spent reviewing strategy. Additional Board meetings are called as required and in total the Board met nine 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 Annual General Meeting (AGM). In addition, all directors are required to stand down and seek re-election to the Board at least once every three years.

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.

Compliance with the provisions of the Combined Code

The Company was compliant with the provisions of the Combined Code on Corporate Governance throughout 2009.

Internal control

The Company recently announced that it had reached a global settlement with the US Department of Justice (DoJ) and the UK Serious Fraud Office (SFO) in connection with long running investigations. These settlements enable the Company to deal finally with significant legacy issues. The Board has reviewed the control failures associated with the DoJ and SFO settlements and believes that the Company has systematically enhanced relevant compliance policies and processes since the conduct referred to in the settlements occurred.

In 2007 the Board appointed an independent committee, the Woolf Committee, to:

- identify the high ethical standards to which a global company should adhere,
- identify the extent to which the Company may currently meet these standards, and
- recommend the action that the Company should take to achieve such standards.

The Committee published its report in 2008 and made 23 recommendations for the Company aimed at achieving leadership standards of responsible business conduct.

The Board believes that, under the leadership of the Chief Executive, good progress has been made in implementing the recommendations in the Woolf Committee's report. All of the recommendations have been embedded into the Operational Framework, which sets the values, policies and processes that guide the work and behaviour of all Group employees. Also, the Company has successfully rolled-out a code of conduct for employees – an essential element of the drive to embed high standards of responsible business conduct across the Group.

The Board has conducted a review of the effectiveness of the Group's system of internal controls, including financial, operational and compliance controls and risk management systems, in accordance with the Combined Code and the Turnbull guidance (as revised).

The attendance by individual directors at meetings of the Board and its committees in 2009 was as follows:

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee	Non-Executive Directors' Fees Committee
Mr P M Anderson ²	2 (2)	–	–	–	–	–
Mr P J Carroll	9 (9)	–	–	9 (9)	–	–
Mr M J Hartnall	9 (9)	6 (6)	–	–	–	–
Mr W P Havenstein ¹	5 (5)	–	–	–	–	1 (1)
Ms L P Hudson ³	2 (2)	–	–	–	–	–
Mr A G Inglis	8 (9)	–	5 (5)	–	–	–
Mr I G King	9 (9)	–	–	–	–	1 (1)
Sir Peter Mason	9 (9)	6 (6)	2 (2)	9 (9)	–	–
Mr R L Oliver	9 (9)	–	–	9 (9)	2 (2)	1 (1)
Mr R Quarta	8 (9)	5 (6)	–	–	6 (6)	–
Mr G W Rose	8 (9)	–	–	–	–	–
Sir Nigel Rudd ⁴	7 (9)	–	3 (3)	–	4 (6)	–
Mr C G Symon	9 (9)	–	–	–	6 (6)	–
Mr R K Uppal	8 (9)	–	4 (5)	–	–	–

Figures in brackets denote the maximum number of meetings that could have been attended.

1. Resigned from the Board on 21 June 2009.

2. Appointed to the Board on 8 October 2009.

3. Appointed to the Board on 26 October 2009.

4. Retired from the Board on 31 December 2009.

BAE Systems has developed a system of internal control that was in place throughout 2009 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 by enabling 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

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 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. This has been subject to regular review over a number of years, which has resulted in a number of refinements being made.

The OAS requires that each part of the business completes a formal review of its compliance against the Operational Framework, including operational and financial controls, and risk management processes. It is signed-off by the managing director of every line of business and relevant functional directors. The OAS is completed every six months and includes a formal assessment of business risk.

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 54 to 73. The financial position of the Group, including information on order book, cash flow, treasury policy and liquidity, can be found in the Financial review on pages 30 to 36. Principal risks are detailed on pages 48 to 51. In addition, the financial statements include, amongst other things, notes on finance costs (page 134), loans and overdrafts (page 148), and financial risk management (page 167).

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.

Relations with shareholders

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 shareholders presentations. This can be accessed via the Company's website, www.baesystems.com.

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 an annual programme of internal audit work
- Considering and making recommendations to the Board on the appointment of the Auditors
- 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
- Agreeing the scope of the Auditors' annual audit programme and reviewing the output

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 2009. 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.

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 external 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 work 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. However, the Committee has agreed the following:

- any non-audit work to be undertaken by the Auditors in excess of £250,000 must be authorised by both the Chairman of the Audit Committee and the Group Finance Director,
- no partner/director of the Auditor's worldwide audit team shall be employed by the Group within two years of the conclusion of a relevant audit,
- no qualified member of the worldwide audit team at manager level or below is to be employed by the Group within two years of the conclusion of a relevant audit, and
- no partner/director of the Auditors not associated with the audit is to be employed by the Group without the approval of the Group Finance Director and the Chairman of the Audit Committee.

On an annual basis the Committee's effectiveness is reviewed as part of the Board's externally facilitated evaluation process.

The Committee met six times in 2009.

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 81). 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.

- 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 Group's Military Air Solutions business based in Warton, Lancashire,
 - management of the BAE Systems Surface Ships business at its Glasgow shipyard shortly after the Company's acquisition of VT Group's 45% shareholding in BVT, and
 - the Pensions Director and the Director, Insurable Risk Services, to receive individual reports on the Group's pension and insurance arrangements, respectively

Financial reporting

The Committee

- reviewed the financial statements and, as part of this process, the significant financial reporting judgements contained within them,
- reviewed 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 2008 and 2009 Annual Reports, and the 2009 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 2009

Internal Audit

The Committee

- reviewed output from the internal audit programme twice during the year and considered progress against the programme,
- agreed the internal audit programme for 2010, and
- reviewed the effectiveness of the Group's Internal Audit function

External auditors

The Committee

- agreed the approach and scope of the audit work to be undertaken by the Auditors,
- reviewed the Group's processes for disclosing information to the Auditors and the statement concerning such disclosure in the Annual Report, and
- reviewed the effectiveness of the Auditors and agreed the fees payable in respect of the 2009 audit work. 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 2010 Annual General Meeting

On behalf of the Audit Committee

Michael Hartnall Audit Committee Chairman

CORPORATE RESPONSIBILITY COMMITTEE REPORT

Members

Andy Inglis (Chairman)
Sir Peter Mason
Paul Anderson

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 assess 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. This will include the Company's Ethics Helpline
- Monitoring the implementation of the Woolf Report and ensure that the global Code of Conduct is regularly reviewed and reflects best practice for such codes
- Ensuring the Corporate Responsibility 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

Andy Inglis

Corporate Responsibility
Committee Chairman

Governance

The Corporate Responsibility Committee was in place throughout 2009 and all its members were independent in accordance with provision A 3.1 of the Combined Code

Sir Nigel Rudd was a member of the committee up to 18 November 2009. Sir Peter Mason was appointed as a member with effect from the same date.

Ravi Uppal also served as a member of the Committee up to 17 February 2010. Paul Anderson was appointed to the Committee with effect from the same date.

The Committee has asked that the Chief Executive, Group General Counsel, Group HR Director, Managing Director Corporate Responsibility, Deputy 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 Corporate Responsibility have direct access to the Chairman of the Committee.

The Committee is responsible for appointing the CR Assurer (presently Deloitte LLP) and keeping under review its fees, independence and objectivity, scope of work and the expertise and resources available to it.

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 met five times in 2009.

Activities

The principal activities undertaken by the Committee during 2009 were as follows:

CR objectives – the Committee agreed management objectives at the start of the year dealing with the following three CR-related matters:

- safety,
- business conduct, and
- diversity and inclusion.

At meetings held during the year the Committee reviewed progress against these objectives. One such meeting was held at one of the Company's major manufacturing sites which provided directors with the opportunity to view the matters covered by the objectives at first hand.

Actual performance against the measures agreed for the 2009 objectives was determined by the Committee at the end of the year and a recommendation was made to the Remuneration Committee as to the level of bonus payable to executive directors as a consequence of this.

The Committee has agreed CR-related management objectives for 2010.

Non-financial risk review – the Committee reviewed the output from the Company's non-financial risk management process and the status of the mitigation actions for the risks identified.

Internal Audit – the Committee received reports from the head of the Company's Internal Audit function covering CR-related audit work undertaken during the year. He also provided the Committee with details of the output from the Company's Operational Assurance Statement (OAS) process – a half-yearly self-assessment process by which businesses and functional heads report on their compliance with the Company's governance requirements and identify key risks.

Responsible business conduct – during the year the Committee monitored management's progress against the milestones set for the implementation of the recommendations in the Woolf Report. In addition, the Committee monitored the roll-out of the Company's Code of Conduct across the Group.

CR assurer – the Committee reviewed a report from the CR Assurer, Deloitte LLP, dealing with the assurance work they undertook on the Company's 2008 Corporate Responsibility Report.

Ethics Helpline – during the year the Committee reviewed the operation of the Ethics Helpline and details of the issues raised during the year.

Corporate Responsibility Report – the Committee reviewed and approved the Company's 2008 Corporate Responsibility Report.

Terms of reference – the Committee reviewed its terms of reference and recommended that certain changes be made to align its future activities more fully with the recommendations in the Woolf Committee's report.

On behalf of the Corporate Responsibility Committee

Andy Inglis Corporate Responsibility Committee Chairman

NOMINATIONS COMMITTEE REPORT

Members

Dick Oliver (Chairman)
Phil Carroll
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 all vacancies for non-executive and, with the assistance of the Chief Executive, executive directors
- Planning for the orderly succession of new 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

Governance

The Nominations Committee was in place throughout 2009. 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 of the Committee as required and meetings will be chaired by Sir Peter Mason, the Board's Senior Independent Director.

The Committee normally asks the Chief Executive and Group HR Director to attend its meetings.

During the year, the Committee retained the services of Zygos Partners to assist in identifying potential non-executive director candidates for nomination to the Board.

The Committee met nine times in 2009.

Dick Oliver
Nominations Committee
Chairman

Activities

The principal activities undertaken by the Committee in the period under review are set out below

Succession

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. On an annual basis the Committee receives a detailed report on the Group's senior executive planning and development processes. This covers the succession plans for key operational and functional positions (including existing executive director appointments) and development priorities and plans for individuals covered by the analysis.

The Committee also reviewed the long term succession plans for non-executive directors looking at the balance of skills and experience available to the Board. In addition, this analysis was applied to the board committees.

Two non-executive recruitment priorities were identified by the Committee during the year. On the basis of the analysis undertaken by the Committee on the background, experience and skills required for these particular positions, external search consultants, Zygos Partners, were engaged to draw-up a long-list of possible candidates for the Committee's consideration. Following further review, short-listed candidates met with Committee members and candidates for nomination to the Board were identified. All Board members were provided with the opportunity to meet the candidates prior to formally considering their appointment. In addition, the candidates were encouraged to undertake their own due diligence on the Company, and, to this end, members of executive management were made available to them. At the end of this process, Paul Anderson and Nick Rose were appointed to the Board to serve as non-executive directors.

During the year, similar rigour was applied to the process used by the Committee in the appointment of Linda Hudson to succeed Walt Havenstein as head of our US business. The succession planning processes that we have developed over the last few years had clearly identified Linda as a succession candidate for this position and, after validating the internal position against the external market using professional search consultants, the Nominations Committee nominated her for appointment.

Non-executive directors are appointed for a term of three years and prior to the end of such a term the Committee is responsible for ensuring that the individual director is consulted on whether he wishes to remain a director, and if he does, to consider whether it would be appropriate to recommend to the Board that he serve for a further three-year term (or shorter).

During the year, Sir Nigel Rudd advised the Committee that, due to other commitments, he did not wish to serve for a further term but agreed to remain on the Board until the end of 2009. Phil Carroll, who had previously agreed to extend his term of office by one year, agreed to a further extension up to the date of the 2010 AGM. Having consulted with Mr Hartnall, the Committee agreed to extend his term of office for a third three-year term and agreed that it would plan for an appropriate individual to be available to succeed him in due course as chairman of the Audit Committee.

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 committees during the year to ensure that they comprised individuals with the necessary skills, knowledge and experience, and also that they comply with the requirements of the Company's Articles of Association.

Conflict of interest

As required by the 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 its renewal.

Board performance evaluation

In his capacity as Chairman of the Board, Mr Oliver consulted the Committee on the annual performance evaluation of the Board, the committees and the directors. The Committee agreed it was appropriate to continue to use the services of Sheena Crane, an experienced consultant, to facilitate this.

On behalf of the Nominations Committee

Dick Oliver Nominations Committee Chairman

REMUNERATION REPORT

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, which conform with the requirements of the Combined Code, can be found on the Company's website or can be obtained from the Company Secretary

Carl Symon
Remuneration Committee
Chairman

The Remuneration report is structured as follows

– Remuneration Committee report	Page 90
– Non-Executive Directors' Fees Committee report	Page 92
– Remuneration reporting	
– Remuneration strategy, policy and service contracts for executive directors	Pages 93 to 103
– Chairman's appointment, term and fees	Page 103
– Non-executive directors' appointment, term and fees	Page 104
– Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions	Pages 105 to 111

Governance

The members of the Committee are independent non-executive directors. Following Sir Nigel Rudd's decision to retire from the Board at the end of 2009, the Board appointed Carl Symon as Chairman of the Remuneration Committee in August 2009 in Sir Nigel's stead.

Dick Oliver, the Company's Chairman, also served as a member of the Committee from 23 September 2009 until 17 February 2010. He was deemed to be independent on his appointment as Board Chairman on 1 July 2004. Nick Rose was appointed to the Committee with effect from 17 February 2010.

The Chief Executive and, other than during the period when he served as a committee member, the Company's Chairman, 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 2009, the Committee met six times and details of attendance at these meetings are provided in the Corporate Governance report on page 83.

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 2009 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, Group 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 (PSP).

On an annual basis, the Committee's effectiveness is reviewed as part of the Board's externally facilitated evaluation process.

Activities

During the period under review, the Committee

- Assessed the level of achievement against financial and non-financial objectives under the annual incentive plan, and determined the levels of payout as detailed on page 99
- Considered the outcome of the performance conditions for the March 2007 Share Matching Plan (SMP) awards and share options, the real growth in EPS over the three-year performance period exceeded 5% pa so that the awards of share options and matching SMP shares vest in full
- Considered the outcome of the performance condition for the March 2007 awards under the PSP, these lapsed as the total shareholder return over the three-year performance period to the end of 2009 of -10.4% was below the median return of the global comparator group of aerospace and defence companies of -5.1%
- Agreed the package for Linda Hudson on her appointment to the Board as President and Chief Executive Officer, BAE Systems, Inc., and an executive director of BAE Systems plc
- Agreed the Chief Executive's recommendation to leave salary and incentive levels for executive directors unchanged for 2010
- Agreed significant changes to US pension arrangements to ensure they remain affordable and competitive
- Retained the same performance conditions for 2010 awards under the SMP and the PSP despite the challenging economic environment

- Increased the proportion of the annual incentive measured against safety and business conduct objectives from approximately 12.6% to 15% to further reinforce key aspects of the Group's Corporate Responsibility agenda
- 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
- Retained the requirement for executive directors and EC members to build up a shareholding over time of at least 200% of salary
- Decided to introduce a claw back arrangement on in-year annual incentives, and future awards under the SMP and PSP prior to vesting
- Consulted with major shareholders on aspects of remuneration strategy and policy

The Company's remuneration strategy, policy and details of executive remuneration are set out on pages 93 to 111 of this Remuneration report

On behalf of the Remuneration Committee

Carl Symon Remuneration Committee Chairman

The table below shows the annual timetable of Committee activities

Directors' and EC members' remuneration	Annual bonus	Share plans	Miscellaneous
Q1 Shareholder consultation on remuneration review Approve remuneration for EC members	Review prior year performance against financial and non-financial objectives. Where applicable, award bonuses 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
Q2			Review pay review for senior executives below the EC
Q3 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	
Q4 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

NON-EXECUTIVE DIRECTORS' FEES COMMITTEE REPORT

Members

Dick Oliver (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

Governance

The Non-Executive Directors' Fees Committee has delegated authority from the Board to agree fees payable to non-executive directors on its behalf

Walt Havenstein was a Committee member up to June 2009. Linda Hudson joined the Committee on her appointment to the Board in October 2009.

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, complexity and international nature 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 time commitments expected of non-executive directors and the market competitive positioning of existing fee levels, the Committee agreed in January 2010 to make no changes to their fees at the current time as detailed on page 104.

On behalf of the Non-Executive Directors' Fees Committee

Dick Oliver Non-Executive Directors' Fees Committee Chairman

REMUNERATION STRATEGY, POLICY AND PACKAGES

Following the annual review in November 2009, the Committee concluded that the current remuneration strategy remains appropriate, and intends to continue with the executive remuneration policy as detailed in this report in 2010 and subsequent years for executive directors and Executive Committee (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.

REMUNERATION STRATEGY

The Company's remuneration strategy is to provide a remuneration package that

- helps to attract, retain and motivate
- is aligned to shareholders' interests
- is competitive against the appropriate market
- encourages and supports a Total Performance culture aligned to the achievement of the Company's strategic objectives
- is fair and transparent
- can be applied consistently throughout the Group

REMUNERATION POLICY

To achieve the strategy, the remuneration policy for executive directors and EC members is to

- Set base salary at around median of the relevant market competitive level
- Reward stretching superior performance with upper quartile reward
- Provide an appropriate balance between
 - short-term and long-term reward
 - 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
- 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 Earnings per Share (EPS) performance through co-investment aligned to the interests of shareholders
Performance Share Plan	Drive and reward delivery of sustained long term EPS and Total Shareholder Return (TSR) performance aligned to the interests of shareholders
Pension provision	Provide competitive and affordable 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

2009 remuneration review

The 2009 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 23 companies (12 larger and 11 smaller) which the Committee believed appropriate for benchmarking UK executive directors' packages.

For the President and Chief Executive Officer of BAE Systems, Inc., regression analysis was used on US aerospace, defence and general industry sector data to produce appropriate market figures consistent with the size and scale of the US business, 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 conclusion

Overall, the review indicated that the structure and level of the packages were not out of line with the market, although the base salaries for both the Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc., who are both relatively new to their roles, were slightly behind their respective benchmarks. Having taken account of the current economic climate, the challenges facing the business going forward and the pay environment for employees in general, the Committee agreed the Chief Executive's recommendation that salary and incentive levels for executive directors remain unchanged for 2010. As part of the overall review of remuneration strategy and in order to maintain the alignment between reward and performance, the Committee agreed clawback arrangements 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. These arrangements are to be applied in respect of the compulsorily deferred element of the in-year annual incentive, the 2010 PSP and SMP awards, and their respective equivalents in future years.

Incentives

The Group's strategy is set out on page 10 along with the Group Strategic Framework. This explains how the Group's strategy is delivered through the Group Strategic Objective, which is to deliver Total Performance through Customer Focus, Financial Performance, Programme Execution and Responsible Behaviour. Underpinning the drive for Total Performance are the Group's Values – Trusted, Innovative and Bold. The Group will focus on six Strategic Actions, which emphasise the home market strategies and are underpinned by the Integrated Business Plan (IBP), which sets out the individual businesses' plans for the next five years in terms of strategy, actions and performance, making sure they are aligned to collectively deliver the Strategic Actions and the Group's strategy.

Each year, the Board agrees the EC's top ten objectives which are those key to delivering the Group's strategy. These are set out on page 11 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 Oliver, 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 2010 annual incentive into the Share Matching Plan (SMP) when the annual incentive is paid in 2011. Further investment can be made on a voluntary basis up to a maximum investment of half their net annual incentive.

Annual Incentive Plan

The annual incentives for 2010 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 safety and business conduct objectives (reinforcing the importance of key aspects of the Group's Corporate Responsibility agenda) combined with the other objectives supporting the Group's strategy. To further reinforce the importance of the Group's Corporate Responsibility agenda, the proportion of the annual incentive driven off safety and business conduct objectives increases from approximately 12.6% in 2009 to 15% for 2010.

The financial targets are derived from the IBP, and are based on earnings and cash targets as 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. Previously cash targets have been based on net cash/debt at the year end. 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 this will continue for 2010. As last year, the payout for achieving on-target performance against the in-year financial targets remains at 40% of maximum. In relation to the profit element, due to the stretching nature of the plan, the Committee has introduced for 2010 a threshold paying 20% 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	
	2009	2010
In-year financial	66.6%	66.6%
Safety and ethics/business conduct	12.6%	15.0%
Other objectives	20.8%	18.4%

The Committee believes that the annual incentive targets for the executive directors are stretching but achievable. The structure of the 2010 annual incentive plan for each of the executive directors is summarised in their individual sections on pages 96 to 98.

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). No changes have been made for the 2010 awards apart from the introduction of a clawback provision detailed above. Full details of the PSP and SMP are contained on pages 100 and 101.

The combination of the annual incentive plan, SMP and PSP provide a balance between short-term cash reward and longer-term share-based reward as illustrated opposite for the Chief Executive. 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 a long-term reward being delivered in shares. The second graph shows

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

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, in order 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 (%)

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 105.

Pension provision

No changes to the pension arrangements for UK executive directors were made in 2009. A review of UK executive pension arrangements is planned for 2010.

A major review of US pensions was undertaken in 2009 to take account of the rapidly changing US pension market and new funding rules which come into effect in 2011. As a result of this review, a number of significant changes were agreed which impact both existing employees and new hires. These also simplify the arrangements going forward by consolidating the numerous legacy plans to provide a much simpler structure for future service benefits. These changes effectively:

- Froze the legacy final salary plans at the end of 2009, with future service for these members being provided by the 2006 Career Average Cash Plan together with a standard 85% Company match on up to 6% of salary in the defined contribution plan (known as the 401(k) Plan). The 2006 Plan provides a cash sum at retirement of 10% of career pay (salary and bonus).
- Bonuses will no longer be pensionable in the 401(k) plans.
- Only a 401(k) plan will be provided for new hires.
- Employees who currently have only a 401(k) plan will move to a standardised plan with either a 50% or 100% Company match (depending on their business) on up to 6% of salary.

The Committee had previously agreed that, from 2008, where bonuses are pensionable, their pensionability is limited to 150% of base salary.

Linda Hudson is a member of the 2006 Plan and had a supplementary pension arrangement (SERP) which sought to match the pension arrangements provided by her previous employer. This uplifted her 2006 Plan accrual from the normal 10% of pay to 15% of pay. Effective in 2010, the SERP providing this additional benefit was reduced in line with the average impact for other US employees such that, from 1 January 2010, her 2006 Plan accrues at the rate of 14.1% of career pay.

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES		2010		2009	
Ian King (Chief Executive)					
Base salary		£900,000 pa			
Annual incentive	Max/on-target (% of salary)	225% / 110%			
	Structure (% of salary)	On-target	Stretch	On-target	Stretch
	Group EPS	36%	90%	30%	75%
	Group cash	24%	60%	30%	75%
	Safety		Up to 16 875%		Up to 14 25%
	Business conduct/Ethics		Up to 16 875%		Up to 14 25%
	Other objectives		Up to 41.25%		Up to 46 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 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)		2010		2009	
Base salary		£622,500 pa			
Annual incentive		150% / 73%			
	Max/on-target (% of salary)	On-target	Stretch	On-target	Stretch
	Structure (% of salary)				
	Group EPS	24%	60%	20%	50%
	Group cash	16%	40%	20%	50%
	Safety		Up to 11 25%		Up to 9 75%
	Business conduct/Ethics		Up to 11 25%		Up to 9 75%
	Other objectives		Up to 27 5%		Up to 30 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 (%)

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES CONTINUED

Linda Hudson (President and Chief Executive Officer of BAE Systems Inc.)		2010		2009*	
Base salary		\$900,000 pa			
Annual incentive	Max/on-target (% of salary)	225% / 110%			
	Structure (% of salary)	On-target	Stretch	On-target	Stretch
	Group EPS	12%	30%	10%	25%
	Group cash	8%	20%	10%	25%
	Business EBITA	24%	60%	20%	50%
	Business cash	16%	40%	20%	50%
	Safety	Up to 16 875%		Up to 14 25%	
	Business conduct/Ethics	Up to 16 875%		Up to 14 25%	
	Other objectives	Up to 41 25%		Up to 46 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		Cash sum at retirement of 14 1% 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		Cash sum at retirement of 15% of career pay (salary plus bonus up to maximum of 150% of salary) for a contribution of 1 5% of pay, plus a 100% Company 401(k) match on contributions to a maximum of 6% of pay	

* From 26 October 2009, the date of Linda Hudson's appointment to the Board

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 (%)

Performance in 2009

The structure of the 2009 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 96 to 98

Financial performance

2009 was a good year in terms of financial performance following the Group's strong performance of recent years. At the Group level, EPS performance was above target, but some way short of stretch performance, whilst stretch performance was achieved on both cash targets. At the operating group level, Programmes & Support and International both exceeded their profit targets but did not hit stretch. Both achieved their stretch cash targets. Electronics, Intelligence & Support and Land & Armaments both hit their stretch profit targets and, whilst both exceeded their cash targets, they did not achieve their stretch cash targets. BAE Systems, Inc. achieved stretch performance on both profit and year end cash and, whilst exceeding its average cash target, fell short of its stretch target. The US pension accounting gain and the regulatory penalties were excluded from the calculation of growth in the Group's underlying EPS performance for incentive purposes.

Non-financial performance

Page 7 set out the EC's top ten objectives for 2009 and the assessment of performance against these, whilst page 40 provides more detailed information on the performance against the specific objectives relating to safety and business conduct. Each senior executive also had a personal safety objective and a personal business conduct objective.

Business conduct All the Group objectives in relation to business conduct were achieved, including those personal to the individual executive directors and EC members. In particular, the 2009 milestones for the Woolf implementation programme were substantively achieved, including the launch of the global Code of Conduct and communication of this to employees through team briefings.

A sample of employees worldwide were invited to participate in a survey on the Group's approach to responsible business conduct which showed a trend increase across all six areas, including an increased awareness of the ethical standards expected.

Safety: The executive directors and EC members conducted the required safety reviews. The minimum safety Level 3 standard was achieved across all lines of business and, at Group level, over 60% of major manufacturing sites reached Level 4. The total incident rate across the Group fell by 33% against the 10% improvement target.

Other aspects of performance Against the remaining top ten Group objectives, excellent progress has been made. Accordingly, the Committee agreed an overall rating of 6.5 out of 7.5. This sets the starting point with further adjustment, up or down, depending on the assessment of the individual executive's overall performance and leadership behavioural performance.

Accordingly, the Committee determined the payout under the 2009 Annual Incentive Plan as follows:

2009 annual incentive payout	Ian King	Linda Hudson*	George Rose
% of stretch	83.0%	87.9%	80.9%
% of base salary	186.7%	179.4%	121.4%
Amount ('000)	£1,680	\$296	£755

* The figures for Linda Hudson are in respect of the period from her appointment to the Board.

In addition:

- The real growth in EPS over the three years to 2009 exceeded 5% pa so that the awards of share options and matching SMP shares granted in 2007 vest in full.
- The Company's TSR for awards of shares made in March 2007 under the PSP did not exceed the median position when compared against the comparator group of 18 other defence and aerospace companies, and accordingly lapsed.

The Committee also determined that the second tranche of shares and cash due to Mike Turner (the previous Chief Executive) on 1 September 2009 in respect of the special incentive awarded to him in October 2007, which vested in full on 1 September 2008, should be released.

VALUE AT 31 DECEMBER 2009 OF £100 INVESTMENT AT
31 DECEMBER 2004 (£)

VALUE AT 31 DECEMBER 2009 OF £100 INVESTMENT (£)

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 2009 on a total shareholder return basis of £100 invested in BAE Systems on 31 December 2004 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.

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 2009 executive pay review. The graph depicts the value for BAE Systems and the comparators at the end of 2009 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 2010 are detailed below. Performance conditions for grants of awards made prior to 2010 are detailed on pages 106 and 107.

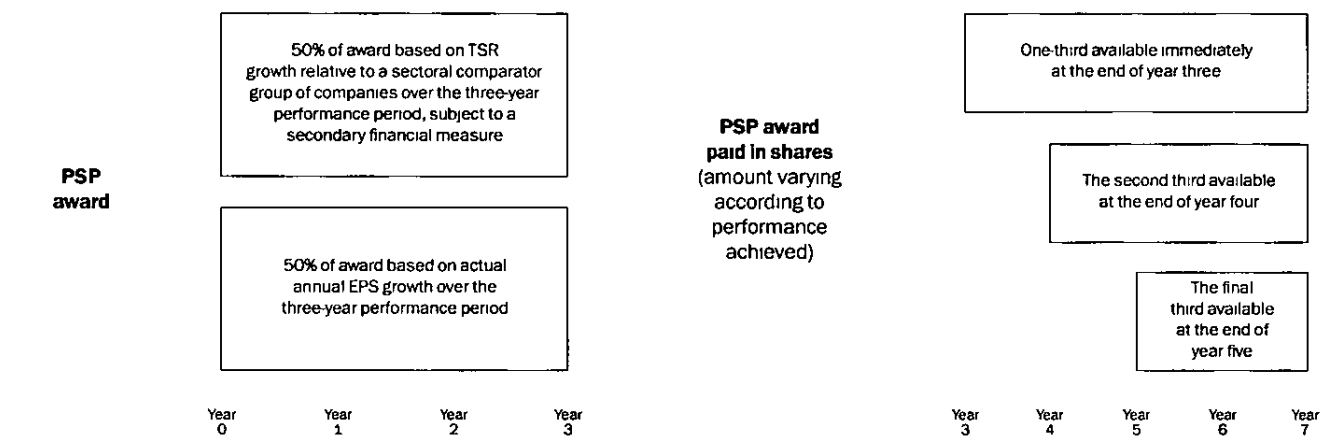
Clawback arrangements have been introduced and will operate in respect of these two plans from the 2010 awards onwards. The arrangements are intended to cover situations, for example, where results are restated or otherwise turn out to be materially inaccurate or where the executive's employment can be terminated for cause.

PERFORMANCE SHARE PLAN (PSP)

Key features for PSP awards in 2010

- 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 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}

Proportion of the award capable of exercise 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 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.

PERFORMANCE CONDITION – PSP^{TSR}

PERFORMANCE CONDITION – PSP^{TSR}

Proportion of the award capable of exercise determined by

(i) the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 18 other international defence and aerospace companies as shown in the table opposite

None of the shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group and 100% vest if it is in the top quintile (i.e. top 20%) as set out opposite,

and

(ii) whether there has been a sustained improvement in the Company's underlying financial performance and whether it is appropriate to release some or all of the awards. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt, 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 2009

The graph opposite summarises the position on the TSR element for all outstanding awards under the PSP as at 31 December 2009

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 March 2007 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 2010

- 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 2009 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 less than 5% pa increasing uniformly to a 2:1 match at 11% pa 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 2010

¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

Share Incentive Plan (SIP)

During 2009 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 2009, all eligible employees (including the UK executive directors) will be entitled to receive shares worth £567. 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 2009	3,585m
All schemes	
10% in any consecutive years	358.5m
Remaining headroom	218.1m
Executive schemes	
5% in any consecutive ten years	179.2m
Remaining headroom	91.2m

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 benefits 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 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. 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) are given a number of choices as previously reported. These are:

- 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.

Ian King is a member of the BAE Systems 2000 Pension Plan (the 2000 Plan), applicable to former employees of Marconi Electronic Systems (MES), and a member 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 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 joined the ExPS in 1999 following the BAe/MES merger. Therefore Ian King's total pension is the sum of his 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.

US pension benefits

Linda Hudson is a member of the 2006 Plan which provides 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). For service up to 1 January 2010, the cash sum accrued at the rate of 15% of career average pay. Following the changes made in 2009, the cash accrual rate from 1 January 2010 will be 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. In 2009, Linda Hudson also received a 100% match on her contributions to her 401(k) plan up to a maximum contribution of 6% of earnings. From 1 January 2010, the match will be 85% up to a maximum contribution of 6% of salary.

Details of post retirement benefits for each of the executive directors who served during 2009 are shown in Table D on page 111 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 the executive directors include a car allowance, the private use of a chauffeur-driven car and a cash allowance for medical examination.

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)	Expiry date 31 December 2010*	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	12 months from the Company, 6 months from the individual

* 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) 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 is subject to a fixed term (which ends on 31 December 2010) and automatically renews for one year periods thereafter 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).

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).

Walt Havenstein, who resigned as a director on 21 June 2009, had a service contract dated 1 December 2006 with a notice period of three months from either party, and ceased to be a Group employee on 20 September 2009. Details of his salary package for 2009 were provided in the 2008 Annual Report and are reported in the tables on pages 109 to 111. No termination payments were made to Walt Havenstein, and all outstanding long term incentive awards and share options lapsed.

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 2009 were as follows: Ian King £40,000 and George Rose £79,500.

CHAIRMAN'S APPOINTMENT, TERM AND FEES

Dick Oliver 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, will be subject to review in 2010.

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
Phil Carroll	07 09 2005	05 05 2010
Michael Hartnall	10 06 2003	09 06 2012
Andy Inglis	13 06 2007	12 06 2010
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. 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, Sir Nigel Rudd retired from the Board on 31 December 2009 having originally been appointed to the Board on 10 September 2006.

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.

The letters of appointment for non-executive directors detail the amount of time it is anticipated that the individual will need to devote to his or her duties as a director, being 15 days per year plus ten additional days for chairing a committee or undertaking the role of Senior Independent Director. 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 2010, the Committee decided that the non-executive directors' fees should remain unchanged at the current time as follows:

	2009 and 2010 fee
Base fee	£66,000
Additional fee for chairing committees	
Audit Committee	£20,000
Corporate Responsibility Committee	£20,000
Remuneration Committee	£20,000
Additional fee for Senior Independent Director	£20,000
Travel allowance (per meeting)*	£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 2009 and 2010:

Non-executive director	2009 and 2010 fee*
Chairman Audit Committee	£86,000
Chairman Corporate Responsibility Committee	£86,000
Chairman Remuneration Committee	£86,000
Senior Independent Director	£86,000
Other non-executive directors	£66,000

* Excludes the travel allowance of £4,000 per meeting referred to above.

On behalf of the Board

Dick Oliver Chairman
 17 February 2010



TABULAR INFORMATION ON DIRECTORS' SHAREHOLDINGS, SHARE-BASED INCENTIVES, EMOLUMENTS AND PENSIONS

TABLE A. DIRECTORS' INTERESTS

	As at 1 January 2009*				As at 31 December 2009			
	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 ¹	—	—	—	—	—	—	—	—
P J Carroll ²	12,000	—	—	—	12,000	—	—	—
M J Hartnall	20,000	—	—	—	20,000	—	—	—
L P Hudson ³	29,473	133,740	99,908	390,549	29,473	133,740	99,908	390,549
A G Inglis	—	—	—	—	10,000	—	—	—
I G King	497,884	1,270,250	155,821	823,106	678,327	1,132,008	527,437	1,325,953
Sir Peter Mason	25,283	—	—	—	25,283	—	—	—
R L Oliver	40,000	—	—	—	40,000	—	—	—
R Quarta	—	—	—	—	—	—	—	—
G W Rose	619,977	484,679	52,286	780,243	806,114	369,554	227,699	951,739
Sir Nigel Rudd ⁴	11,400	—	—	—	11,400	—	—	—
C G Symon	—	—	—	—	10,000	—	—	—
R K Uppal	—	—	—	—	—	—	—	—

* or upon appointment

1 Appointed as a director on 8 October 2009

2 The ordinary shares held by Phil Carroll are represented by 3 000 American Depositary Shares

3 Appointed as a director on 26 October 2009

4 Retired as a director on 31 December 2009

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 2009. There have been no changes in the interests of the current directors listed in the table above between 31 December 2009 and 17 February 2010 with the exception of the interests in the ordinary shares of Ian King and George Rose who have each acquired an additional 105 ordinary shares since 31 December 2009 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 678,432 and 806,219, respectively. Nick Rose was appointed to the Board on 8 February 2010. On his appointment, and at the date of this report, his shareholding in BAE Systems was nil, he subsequently acquired 25,000 ordinary shares in BAE Systems on 19 February 2010.

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 106 to 111.

TABLE B SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – IAN KING

Share options	1 January 2009	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2009	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP ^{TSR}	60,535	–	60,535	–	–	nil	30 03 04	30 03 09	3 26	30 03 09 ^{1 2}	–
PSP ^{TSR}	98,624	–	49,311	–	49,313	nil	24 03 05	24 03 09	3 53	24 03 09 ^{1,3}	24 03 12
PSP ^{TSR}	96,962	–	–	17,163	–	nil	12 04 06	03 04 09	–	12 04 09	12 04 13
	–	–	26,599	–	53,200	nil	12 04 06	15 04 09	3 35	12 04 09 ^{1 4}	12 04 13
PSP ^{TSR}	115,973	–	–	–	115,973	nil	30 03 07	–	–	30 03 10 ⁵	30 03 14
PSP ^{TSR}	122,039	–	–	–	122,039	nil	26 03 08	–	–	26 03 11 ⁶	26 03 15
PSP ^{EPS}	122,039	–	–	–	122,039	nil	07 05 08	–	–	26 03 11 ⁶	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
	823,106	656,455	136,445	17,163	1,325,953						
ExSOP	138,242	–	–	138,242	–	4 21	20 12 99	20 12 09	–	20 12 02 ¹	20 12 09
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
	1,270,250	–	–	138,242	1,132,008						
LTIPs	1 January 2009	Granted during the year	Vested during the year	Lapsed during the year	31 December 2009	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	–		
SMP	109,411	–	–	–	109,411	4 86	26 03 08	26 03 11 ⁶	–		
SMP	–	371,616	–	–	371,616	3 43	24 03 09	24 03 12 ⁶	–		
	155,821	371,616	–	–	527,437						

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 106 and 107

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 As (2) above. The option over shares remaining at the year end is exercisable in two tranches on the fourth and fifth anniversary of grant

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 100 and 101. PSP awards granted since 2008 attract dividends prior to vesting

PSP^{TSR} – nil vesting if the Company's Total Shareholder Return (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, and

(iii) **2003 grant** – as in (i) but performance is retested at the end of years four and five against the full period from grant

(iv) **1999 grant** (following the BAe/MES merger) under the predecessor Executive Share Option Scheme: the grant to George Rose was conditional on the satisfaction of a performance condition based on the achievement of merger integration cost savings over a three-year performance period, and the grant to Ian King could only be exercised if the pre-exceptional EPS for any three-year period over the ten-year option life exceeded the sum of inflation for that period and real growth of 9% was achieved

TABLE B SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – GEORGE ROSE

Share options	1 January 2009	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2009	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP ^{TSR}	86,832	–	86,832	–	–	nil	30 09 03	31 07 09	3 10	30 09 08 ^{1 2}	–
PSP ^{TSR}	76,701	–	76,701	–	–	nil	30 03 04	31 07 09	3 10	30 03 09 ^{1 2}	–
PSP ^{TSR}	126,263	–	63,130	–	63,133	nil	24 03 05	31 07 09	3 10	24 03 09 ^{1 3}	24 03 12
PSP ^{TSR}	123,831	–	–	21,919	–	nil	12 04 06	03 04 09	–	12 04 09	12 04 13
	–	–	33,970	–	67,942	nil	12 04 06	31 07 09	3 10	12 04 09 ^{1 4}	12 04 13
PSP ^{TSR}	122,538	–	–	–	122,538	nil	30 03 07	–	–	30 03 10 ⁵	30 03 14
PSP ^{TSR}	122,039	–	–	–	122,039	nil	26 03 08	–	–	26 03 11 ⁶	26 03 15
PSPE ^{PS}	122,039	–	–	–	122,039	nil	07 05 08	–	–	26 03 11 ⁶	26 03 15
PSP ^{TSR}	–	227,024	–	–	227,024	nil	24 03 09	–	–	24 03 12 ⁶	24 03 16
PSPE ^{PS}	–	227,024	–	–	227,024	nil	24 03 09	–	–	24 03 12 ⁶	24 03 16
	780,243	454,048	260,633	21,919	951,739						
ExSOP	115,125	–	–	115,125	–	4 21	20 12 99	20 12 09	–	20 12 02 ¹	20 12 09
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
	484,679	–	–	115,125	369,554						

LTIPs	1 January 2009	Granted during the year	Vested during the year	Lapsed during the year	31 December 2009	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 ⁶	–
SMP	–	175,413	–	–	175,413	3 43	24 03 09	24 03 12 ⁶	–
	52,286	175,413	–	–	227,699				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 106 and 107

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 As (2) above The option over shares remaining at the year end is exercisable in two tranches on the fourth and fifth anniversary of grant

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 101. SMP awards attract dividends prior to vesting

2009 award – 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 2009 was 359.5p (2008 376.75p). The range during the year was 306p to 408.25p

Aggregate amount of gains made by directors

The aggregate amount of gains made by directors from the exercise of share options in 2009, as calculated at the date of exercise, was £1,268,104 (2008 £6,278,313). The net aggregate value of assets received by directors in 2009 from long-term incentive plans, as calculated at the date of vesting, was £247,044 (2008 £1,931,858)

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 2009	Granted during the year	Exercised or released during the year	Lapsed during the year	31 December 2009	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 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 ²	26 03 15
PSP ^{TSR}	–	104,813	–	–	104,813	–	24 03 09	–	–	24 03 12 ²	24 03 16
PSP ^{EPS}	–	104,813	–	–	104,813	–	24 03 09	–	–	24 03 12 ²	24 03 16
	180,923	209,626	–	–	390,549						
ExSOP	133,740	–	–	–	133,740	4 57	30 03 07	–	–	30 03 10 ³	30 03 17
	133,740	–	–	–	133,740						

LTIPs	1 January 2009	Granted during the year	Vested during the year	Lapsed during the year	31 December 2009	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 ²	–
	–	99,908	–	–	99,908				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 106 and 107

1 The outstanding award lapsed after the end of the financial year having not met the performance condition

2 Subject to a performance condition that is yet to be tested

3 Subject to a performance condition that has been met

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 B SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – WALT HAVENSTEIN¹

Share options	1 January 2009	Granted during the year	Exercised or released during the year	Lapsed during the year	31 December 2009 ²	Exercise price £	Date of grant	Date of exercise release or lapse	Market price on release £	Date from which exercisable	Expiry date
PSP ^{TSR}	26,455	–	26,455	–	–	–	30 03 04	30 03 09	3 23	–	–
PSP ^{TSR}	40,423	–	20,211	–	–	–	24 03 05	24 03 09	3 49	–	–
	–	–	–	20,212	–	–	24 03 05	20 09 09	–	–	–
PSP ^{TSR}	6,440	–	–	6,440	–	–	22 12 05	20 09 09	–	–	–
PSP ^{TSR}	64,302	–	–	11,382	–	–	12 04 06	03 04 09	–	–	–
	–	–	17,640	–	–	–	12 04 06	14 04 09	3 26	–	–
	–	–	–	35,280	–	–	12 04 06	20 09 09	–	–	–
PSP ^{TSR}	83,543	–	–	83,543	–	–	30 03 07	20 09 09	–	–	–
PSP ^{TSR}	115,749	–	–	115,749	–	–	26 03 08	20 09 09	–	–	–
PSP ^{EPS}	115,749	–	–	115,749	–	–	07 05 08	20 09 09	–	–	–
PSP ^{TSR}	–	241,988	–	241,988	–	–	24 03 09	20 09 09	–	–	–
PSP ^{EPS}	–	241,989	–	241,989	–	–	24 03 09	20 09 09	–	–	–
	452,661	483,977	64,306	872,332	–						
ExSOP	90,949	–	–	90,949	–	2 64	24 03 05	20 09 09	–	–	–
ExSOP	14,923	–	–	14,923	–	3 56	22 12 05	20 09 09	–	–	–
ExSOP	96,453	–	–	96,453	–	4 28	12 04 06	20 09 09	–	–	–
ExSOP	125,315	–	–	125,315	–	4 57	30 03 07	20 09 09	–	–	–
	327,640	–	–	327,640	–						

LTIPs	1 January 2009	Granted during the year	Vested during the year	Lapsed during the year	31 December 2009 ²	Market price at date of award £	Date of award	Date of vesting/lapse	Market price on vesting £
SMP	18,947	–	–	18,947	–	4 57	22 03 07	20 09 09	–
SMP	26,118	–	–	26,118	–	4 86	26 03 08	20 09 09	–
SMP	–	252,020	–	252,020	–	3 43	24 03 09	20 09 09	–
	45,065	252,020	–	297,085	–				
RSP	10,249	–	10,249	–	–	4 18	12 04 06	14 04 09	3 26
	10,249	–	10,249	–	–				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 106 and 107, except for the RSP for which the performance condition is set out below

1 Resigned as a director on 21 June 2009 and ceased to be a Group employee on 20 September 2009

2 As at 21 June 2009 the date that Walt Havenstein resigned from the Board options and awards outstanding totalled 327,640 under ExSOP, 860,950 under the PSP, and 297,085 under the SMP

In addition, Walt Havenstein had a cash-settled Stock Appreciation Right (SAR) over 53,010 ordinary shares granted on 27 November 2000 at a SAR price of £3.73 exercisable from 27 November 2003 until 27 November 2010. This was exercisable only if growth in pre-exceptional EPS for any three-year period over the ten-year life of the SAR exceeded the sum of inflation for that period and a growth requirement of 9%, which was met. The SAR lapsed on 20 September 2009.

The 2004 and 2005 PSP awards and the 2005 ExSOP options granted to Walt Havenstein were granted under the Stock Appreciation Rights Schedule to those plans. The exercise price referred to for the latter is the SAR price.

The Restricted Share Plan (RSP) was replaced by the SMP in 2007. The matching award of shares under the former RSP was not historically subject to performance criteria as it was designed to retain key staff and encourage executives to re-invest in Company shares the cash bonuses that they had earned under the annual bonus plan which was itself subject to performance conditions.

Note: Awards granted to Walt Havenstein (a US national) under the PSP were technically characterised as long-term incentives rather than options as, subject to the attainment of the performance condition, they were 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. Gains on delivered PSP awards for Walt Havenstein are included in the directors' gains on LTIPs figure on page 107 whilst PSP gains for the UK-based directors are included in the share option gains figure.

TABLE C DIRECTORS' REMUNERATION

	2009						2008					
	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	–	63	–	663	–	600	–	59	–	659
Executive directors												
W P Havenstein ¹	294	–	–	11	–	305	486	–	1,013	29	–	1,528
L P Hudson ²	105	–	189	9	–	303	n/a	n/a	n/a	n/a	n/a	n/a
I G King	900	–	1,680	70	–	2,650	678	–	1,275	169	–	2,122
G W Rose	623	–	755	74	–	1,452	593	–	695	72	–	1,360
M J Turner ³	–	–	–	–	591	591	667	–	1,405	89	1,028	3,189
Non-executive directors												
P M Anderson ²	–	15	–	–	4	19	n/a	n/a	n/a	n/a	n/a	n/a
P J Carroll	–	66	–	–	24	90	–	63	–	–	28	91
M J Hartnall	–	86	–	–	4	90	–	83	–	–	8	91
A G Inglis	–	86	–	–	4	90	–	73	–	–	8	81
Sir Peter Mason	–	86	–	–	4	90	–	78	–	–	8	86
R Quarta	–	66	–	–	4	70	–	63	–	–	8	71
Sir Nigel Rudd ⁴	–	81	–	–	4	85	–	78	–	–	8	86
C G Symon ⁵	–	71	–	–	24	95	–	35	–	–	12	47
R K Uppal ⁵	–	66	–	–	24	90	–	47	–	–	12	59
P A Weinberg ³	n/a	n/a	n/a	n/a	n/a	n/a	–	27	–	–	12	39
	1,922	1,223	2,624	227	687	6,683	2,424	1,147	4,388	418	1,132	9,509

- 1 Resigned in 2009
2 Appointed in 2009
3 Retired in 2008
4 Retired at the end of 2009
5 Appointed in 2008

All emoluments and compensation paid to the directors during the year are shown above. Where the individual was appointed during the year the amount shown is for the period from appointment.

The benefits received by the UK based executive directors include, where applicable, the provision of a car allowance, the private use of a chauffeur-driven car and spouse attendance at corporate events. The benefits received by the Chairman, Dick Oliver, include the private use of a chauffeur-driven car and spouse attendance at corporate events.

The benefits received by the US-based executive directors include a cash allowance for a car, medical examination, dental benefits and insured life benefits. In addition, the benefits received by Linda Hudson also include \$8,455 (£5,400) in respect of private use of a Company plane.

Walt Havenstein also received \$442,613 (£282,695) in respect of normal salary and benefits, including a payment for unused holiday, during the period following his retirement from the Board on 21 June 2009 until he left Group employment on 20 September 2009. No termination payment was made to Mr Havenstein in respect of his leaving the Board or the Group.

The other pay received by Mike Turner in 2009 comprised the balance (£590,625) of the cash element of his special incentive, referred to on page 99 and previously disclosed in the 2008 and 2007 Remuneration reports, which was paid to him in September 2009 following the first anniversary of his retirement. The special incentive, awarded in October 2007, comprised a contingent cash payment of £1,181,250 and a contingent award of 231,618 shares (attracting reinvested dividends) releasable in two tranches subject to performance conditions which were subsequently satisfied in full. On 1 September 2009 the balance of the share element of his special incentive was released to him for nil consideration, the number of shares released comprised the balance (115,809) of the shares under award and 8,241 shares deriving from reinvested dividends. The market price of the Company's ordinary shares on 1 September 2009 was 315.6p.

The other pay received by the non-executive directors represents the Travel Allowance (previously Transatlantic Allowance) of £4,000 per meeting as set out on page 104.

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. In 2009 his remuneration was £246,954 (2008 £265,480) in respect of consultancy fees for his role as a member of the Home Market Advisory Board for Saudi Arabia. Sir Richard ceased to be a member of the Advisory Board upon the expiry of his agreed contractual term on 28 February 2010.

There were no other payments to former directors during the year other than the Company pension payments to Sir Richard Lapthorne and Sir Peter Gershon referred to in the notes to Table D on page 111.

TABLE D POST-RETIREMENT BENEFITS

	Age	NRA*	Accrued benefit at 31 December 2009 ¹ £ pa	Increase in accrued benefits £ pa	Change in accrued pension after allowing for inflation £ pa	Transfer value at 1 January 2009 ² £	Transfer value at 31 December 2009 £	Director's contributions £	Increase in value less director's contributions £
W P Havenstein ³	60	60	175,199	18,728	15,412	1,745,364	1,920,718	2,276	173,078
L P Hudson ⁴	59	65	347,088	17,638	15,951	229,920	242,180	379	11,881
I G King	53	62	509,944	84,699	75,110	4,672,376	6,780,197	72,000	2,035,821
G W Rose ⁵	57	60	366,564	35,795	19,256	5,573,907	6,840,222	57,663	1,208,652

* 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 amount shown for Linda Hudson is at 26 October 2009. The increase in transfer value arising from the change in assumptions is: Walt Havenstein £53,887, Linda Hudson £(1,858), Ian King £855,144, George Rose £429,879
- 3 Walt Havenstein resigned from the Board on 21 June 2009, left the Group's employment on 20 September 2009, and subsequently started to draw his plan benefits as an annual pension. His accrued pension comprises £20,549 from a contributory Qualified Plan and £154,650 from Non-Qualified Plans. In addition, Walt Havenstein participated 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 2009, the Company paid contributions of \$11,025 (£6,829) into this 401(k) arrangement. Walt Havenstein was paid in US dollars. Of the change in the accrued benefit and the transfer value £(19,782) and £(216,871), respectively, is due to currency movements.
- 4 Linda Hudson was appointed to the Board on 26 October 2009 and 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 £44,379 from a contributory Qualified Plan and £302,709 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. The Company paid no contributions to this 401(k) arrangement during the period from 26 October 2009 to 31 December 2009. Linda Hudson is paid in US dollars. Of the change in the accrued benefit and the transfer value £3,512 and £2,450, respectively, is due to currency movements.
- 5 George Rose has an unapproved retirement arrangement for pensionable service before 5 April 2006 that is partly funded and partly unfunded. No company contributions have been made to these arrangements during the year.

Sir Peter Gershon and Sir Richard Laphorne, both former directors, have unfunded pension arrangements. In 2009, the Company paid Sir Peter Gershon a pension of £109,230 (in 2008 a cash lump sum of £334,805 and pension of £18,188 was paid) and Sir Richard Laphorne a pension of £100,058 (in 2008 a pension of £96,367 was paid) in respect of these arrangements.

OTHER STATUTORY AND REGULATORY INFORMATION

Principal activities

The BAE Systems Group delivers, through its wholly-owned 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 customer support services

Directors

The current directors who served during the 2009 financial year are listed on pages 76 and 77. Of those directors, Paul Anderson was appointed to the Board on 8 October 2009 and Linda Hudson on 26 October 2009. Walt Havenstein served as a director during the period up to his resignation from the Board on 21 June 2009. Sir Nigel Rudd also served as a director throughout the period up to his retirement from the Board on 31 December 2009. In addition, Nick Rose was appointed to the Board on 8 February 2010.

Dividend

An interim dividend of 6.4p per share was paid on 30 November 2009. The directors propose a final dividend of 9.6p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2010 to shareholders on the share register on 23 April 2010.

Annual General Meeting (AGM)

The Company's AGM will be held on 5 May 2010. 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, 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 2009 by suppliers was 31 days (2008 34 days).

Charitable donations

During 2009, the amount donated for charitable purposes in the UK was £1.6m (2008 £3.4m). Further details of the Company's charitable activities are set out on page 44.

Political donations

No political donations were made in 2009.

Issued share capital

As at 31 December 2009, BAE Systems' issued share capital of £89,614,347 comprised 3,584,573,848 ordinary shares of 2.5p each and one Special Share of £1.

As agreed by the shareholders at the 2009 AGM, the Company's Articles of Association were amended with effect from 1 October 2009 to remove the requirement for the Company to have an authorised share capital, the concept of which was abolished under the Companies Act 2006.

Treasury shares

No treasury shares were acquired by the Company during 2009. As at 1 January 2009, the number of shares held in treasury totalled 55,038,953 (having a total nominal value of £1,375,974 and representing 1.54% of the Company's called up share capital at 1 January 2009). During 2009, the Company used 11,086,593 treasury shares (having a total nominal value of £277,165 and representing 0.31% of the Company's called up share capital at 31 December 2009) to satisfy awards under the Free and Matching elements of the Share Incentive Plan and options under the Save-As-You-Earn Share Option Scheme. Of the 7,791,629 treasury shares utilised in respect of the Share Incentive Plan, the 4,783,293 treasury shares used in respect of the Free Shares element of the Plan were disposed of by the Company for nil consideration, whilst the 3,008,336 treasury shares used in respect of the Matching Shares element were disposed of by the Company for a total consideration of £10,338,290. The 3,294,964 treasury shares utilised under the Save-As-You-Earn Option Scheme were disposed of by the Company for a total consideration of £5,140,144. As at 31 December 2009, 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 31 December 2009).

The rights to such shares are restricted in accordance with the Companies Acts 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 or by proxy and entitled to vote shall have one vote and, 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, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the chief executive and any executive chairman are British.

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 17 February 2010, 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	5.05%
Barclays PLC	3.98%
BlackRock, Inc	7.52%
Invesco Ltd	5.08%
Franklin Resources Inc, and affiliates	4.92%
Legal & General Group Plc	3.96%

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

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, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the chief executive and any executive chairman are British

At the 2010 AGM a special resolution will be put to shareholders proposing amendments to the existing Articles of Association primarily in order to incorporate a small number of provisions in the Companies Act 2006

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 2009 AGM, the directors were given the power to buy back a maximum number of 352,791,045 ordinary shares at a minimum price of 2.5p each. The maximum price was 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. This power will expire at the earlier of the conclusion of the 2010 AGM or 30 June 2010. A special resolution will be proposed at the 2010 AGM to renew the Company's authority to acquire its own shares

At the 2009 AGM, the directors were given the power to issue new shares up to a nominal amount of £29,396,313. This power will expire on the earlier of the conclusion of the 2010 AGM or 30 June 2010. Accordingly, a resolution will be proposed at the 2010 AGM to renew the Company's authority to issue further new shares. At the 2009 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £29,396,313 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2010 AGM or 30 June 2010, and a resolution will be proposed at the 2010 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 2009 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 £1.5bn (subsequently reduced to £1.455bn) Revolving Credit Facility dated 1 February 2005 (as amended) and a £500m Letter of Credit Facility dated 27 March 2006, 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 2009.
- The Company has entered into a Restated and Amended Shareholders Agreement with European Aeronautic Defence and Space Company EADS NV (EADS) and Finmeccanica SpA (Finmeccanica) relating to MBDA SAS 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 North America Inc (now BAE Systems, Inc.) and BAE Systems Holdings Inc entered into a Special Security Agreement dated 29 November 2000 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 July 2009, BVT Surface Fleet Limited (now BAE Systems Surface Ships Limited) and the UK MoD entered into a definitive Terms of Business Agreement (TOBA) which sets out a 15-year partnering arrangement, including lead roles for the BVT business on defined surface shipbuilding and support programmes. Where the MoD considers that a proposed Change in Control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the Change in Control shall not proceed until agreement with the MoD is established. In the event that there is a Change in Control of BAE Systems Surface Ships Limited notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the TOBA immediately without compensation or termination charges.

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 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

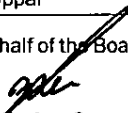
Responsibility statement of the directors in respect of the Annual Report and financial statements

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	Chief Operating Officer, President and Chief Executive Officer of BAE Systems, Inc
George Rose	Group Finance Director
Paul Anderson	Non-executive director
Phil Carroll	Non-executive director
Michael Hartnall	Non-executive director
Andy Inglis	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


David Parkes Company Secretary
17 February 2010

6. Financial Statements

Financial Performance is a key element of the Group Strategic Objective of Total Performance

Independent auditors' report	119
Consolidated financial statements	120
Notes to the Group accounts	124
Company balance sheet	171
Notes to the Company accounts	172
Five-year summary	180
Shareholder information	182
Financial calendar	183
Glossary	184

F-35 STATIC TESTING

BAE Systems brings military aircraft expertise that is critical to the F-35 Lightning II airframe and systems. The Structural and Dynamic Test Facility is BAE Systems' centre of excellence for structural testing, responsible for providing evidence that airframes meet the design requirements for structural strength and durability.

INDEX TO THE ACCOUNTS

	Note	Page
Independent auditors' report to the members of BAE Systems plc		119
Index to the Group accounts		
Accounting policies	1	124
Acquisition of subsidiaries	29	163
Changes in accounting policies	2	129
Consolidated balance sheet		122
Consolidated cash flow statement		123
Consolidated income statement		120
Consolidated statement of changes in equity		121
Consolidated statement of comprehensive income		121
Contingent liabilities and commitments	23	156
Disposals	9	139
Dividends	28	162
Earnings per share	10	139
Employees and directors	7	135
Equity accounted investments	14	144
Events after the balance sheet date	33	170
Finance costs	6	134
Financial risk management	30	167
Five-year summary		180
Group entities	32	170
Intangible assets	11	140
Inventories	18	147
Investment property	13	143
Loans and overdrafts	19	148
Net cash as defined by the Group	27	162
Operating costs	4	133
Other financial assets and liabilities	17	147
Other income	5	134
Other investments	15	145
Property, plant and equipment	12	142
Provisions	22	155
Reconciliation of operating business cash flow	26	161
Related party transactions	31	170
Retirement benefit obligations	21	150
Segmental analysis	3	130
Share-based payments	25	158
Share capital and other reserves	24	157
Tax	8	136
Trade and other payables	20	149
Trade and other receivables	16	146

	Note	Page
Index to the Company accounts		
Accounting policies	1	172
Company balance sheet		171
Contingent liabilities and commitments	9	177
Creditors	7	176
Debtors	4	175
Employee share schemes	11	178
Investments in subsidiary undertakings	3	174
Loans and overdrafts	6	176
Other financial assets and liabilities	5	175
Other information	14	179
Provisions for liabilities and charges	8	177
Reserves	12	179
Share capital	10	177
Statutory reserve	13	179
Tangible fixed assets	2	174

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF BAE SYSTEMS PLC

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Group and Parent Company Balance Sheets, the Group Consolidated Cash Flow Statement, the Group Statement of Changes in Equity and related notes. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 115, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's web-site at www.frc.org.uk/apb/scope/UKP.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2009 and of the Group's loss for the year then ended,
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU,
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice,
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006, and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006, and
- the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

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

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us, or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 84, in relation to going concern, and
- the part of the Corporate Governance Statement on pages 83 to 84 in the Directors' report relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review.

A G Cates (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
London

17 February 2010

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Notes	2009 £m	Total 2009 £m	2008 £m	Total 2008 £m
Continuing operations					
Combined sales of Group and equity accounted investments	3		22,415		18,543
Less share of sales of equity accounted investments	3		(2,041)		(1,872)
Revenue	3		20,374		16,671
Operating costs	4		(20,060)		(15,386)
Other income	5		465		415
<i>Group operating profit excluding amortisation and impairment of intangible assets</i>		2,038		2,003	
<i>Amortisation</i>	11	(286)		(247)	
<i>Impairment</i>	11	(973)		(56)	
Group operating profit			779		1,700
<i>Share of results of equity accounted investments excluding finance costs and taxation expense</i>		233		132	
<i>Financial (expense)/income of equity accounted investments</i>	6	(7)		44	
<i>Taxation expense of equity accounted investments</i>		(23)		(37)	
Share of results of equity accounted investments	14	203		139	
<i>Goodwill impairment in respect of equity accounted investments</i>	14	-		(121)	
Contribution from equity accounted investments			203		18
<i>EBITA¹ excluding non-recurring items</i>		2,220		1,897	
<i>Profit on disposal of businesses²</i>	9	68		238	
<i>Pension curtailment gains²</i>		261		-	
<i>Regulatory penalties³</i>		(278)		-	
<i>EBITA¹</i>		2,271		2,135	
<i>Amortisation</i>		(286)		(247)	
<i>Impairments</i>		(973)		(177)	
<i>Financial (expense)/income of equity accounted investments</i>	6	(7)		44	
<i>Taxation expense of equity accounted investments</i>		(23)		(37)	
Operating profit	3		982		1,718
Finance costs	6				
<i>Financial income</i>		1,573		3,380	
<i>Financial expense</i>		(2,273)		(2,727)	
			(700)		653
Profit before taxation			282		2,371
Taxation expense	8				
<i>UK taxation</i>		(105)		(351)	
<i>Overseas taxation</i>		(222)		(252)	
			(327)		(603)
(Loss)/profit for the year			(45)		1,768
Attributable to					
<i>BAE Systems shareholders</i>			(67)		1,745
<i>Minority interests</i>			22		23
			(45)		1,768
(Loss)/earnings per share	10				
<i>Basic (loss)/earnings per share</i>			(1.9)p		49 6p
<i>Diluted (loss)/earnings per share</i>			(1.9)p		49 5p

1 Earnings before amortisation and impairment of intangible assets finance costs and taxation expense
2 Included in other income
3 Included in operating costs

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	Notes	2009 £m	2008 £m
(Loss)/profit for the year		(45)	1,768
Other comprehensive income			
Currency translation on foreign currency net investments			
Subsidiaries		(246)	807
Equity accounted investments	14	(56)	197
Amounts (charged)/credited to hedging reserve		(393)	469
Gain on revaluation of step acquisition		103	-
Net actuarial losses on defined benefit pension schemes			
Subsidiaries		(2,008)	(1,937)
Equity accounted investments		(54)	(60)
Fair value movements on available-for-sale investments		2	-
Recycling of cumulative currency translation on disposal		-	1
Current tax on items taken directly to equity	8	64	58
Deferred tax on items taken directly to equity			
Subsidiaries	8	562	425
Equity accounted investments		16	17
Total other comprehensive income for the year (net of tax)		(2,010)	(23)
Total comprehensive income for the year		(2,055)	1,745
Attributable to			
Equity shareholders		(2,077)	1,722
Minority interests		22	23
		(2,055)	1,745

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves ¹ £m	Retained earnings £m	Total £m	Minority interests £m	Total equity £m
At 1 January 2009	90	1,238	5,974	(68)	7,234	55	7,289
Total comprehensive income for the year	-	-	(511)	(1,566)	(2,077)	22	(2,055)
Share-based payments	-	-	-	52	52	-	52
Share options							
Proceeds from shares issued	-	5	-	-	5	-	5
Purchase of own shares	-	-	-	(25)	(25)	-	(25)
Ordinary share dividends	-	-	-	(534)	(534)	(5)	(539)
At 31 December 2009	90	1,243	5,463	(2,141)	4,655	72	4,727
At 1 January 2008	90	1,222	4,631	23	5,966	36	6,002
Total comprehensive income for the year	-	-	1,343	379	1,722	23	1,745
Share-based payments	-	-	-	51	51	-	51
Share options							
Proceeds from shares issued	-	16	-	-	16	-	16
Purchase of own shares	-	-	-	(43)	(43)	-	(43)
Other	-	-	-	-	-	7	7
Ordinary share dividends	-	-	-	(478)	(478)	(11)	(489)
At 31 December 2008	90	1,238	5,974	(68)	7,234	55	7,289

¹ An analysis of other reserves is provided in note 24

CONSOLIDATED BALANCE SHEET

as at 31 December

	Notes	2009 £m	2008 £m
Non-current assets			
Intangible assets	11	11,253	12,306
Property, plant and equipment	12	2,552	2,446
Investment property	13	111	112
Equity accounted investments	14	846	1,034
Other investments	15	6	6
Other receivables	16	201	162
Other financial assets	17	133	514
Deferred tax assets	8	1,517	1,026
		16,619	17,606
Current assets			
Inventories	18	887	926
Trade and other receivables including amounts due from customers for contract work	16	3,764	3,831
Current tax		17	14
Other investments	15	211	–
Other financial assets	17	216	674
Cash and cash equivalents		3,693	2,624
		8,788	8,069
Total assets	3	25,407	25,675
Non-current liabilities			
Loans	19	(2,840)	(2,608)
Trade and other payables	20	(522)	(701)
Retirement benefit obligations	21	(4,679)	(3,365)
Other financial liabilities	17	(261)	(383)
Deferred tax liabilities	8	(8)	(80)
Provisions	22	(377)	(459)
		(8,687)	(7,596)
Current liabilities			
Loans and overdrafts	19	(453)	(173)
Trade and other payables	20	(10,218)	(9,165)
Other financial liabilities	17	(94)	(362)
Current tax		(676)	(704)
Provisions	22	(552)	(386)
		(11,993)	(10,790)
Total liabilities	3	(20,680)	(18,386)
Net assets		4,727	7,289
Capital and reserves			
Issued share capital	24	90	90
Share premium		1,243	1,238
Other reserves	24	5,463	5,974
Accumulated losses		(2,141)	(68)
Total equity attributable to equity holders of the parent		4,655	7,234
Minority interests		72	55
Total equity		4,727	7,289

Approved by the Board on 17 February 2010 and signed on its behalf by

I G King
Chief Executive



G W Rose
Group Finance Director



CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December

	Notes	2009 £m	2008 £m
(Loss)/profit for the year		(45)	1,768
Taxation expense		327	603
Share of results of equity accounted investments	14	(203)	(139)
Net finance costs		700	(653)
Depreciation, amortisation and impairment		1,600	755
Gain on disposal of property, plant and equipment	4, 5	(17)	(33)
Gain on disposal of investment property	5	–	(5)
Gain on disposal of businesses	5	(68)	(238)
Cost of equity-settled employee share schemes		52	51
Movements in provisions		52	(115)
Decrease in liabilities for retirement benefit obligations		(657)	(272)
Decrease/(increase) in working capital			
Inventories		6	46
Trade and other receivables		52	(5)
Trade and other payables		433	246
Cash inflow from operating activities		2,232	2,009
Interest paid		(250)	(249)
Interest element of finance lease rental payments		(2)	(5)
Taxation paid		(350)	(261)
Net cash inflow from operating activities		1,630	1,494
Dividends received from equity accounted investments	14	77	89
Interest received		66	156
Purchases of property, plant and equipment		(483)	(520)
Purchases of intangible assets		(42)	(32)
Proceeds from sale of property, plant and equipment		36	44
Proceeds from sale of investment property		–	5
Purchase of subsidiary undertakings	27, 29	(357)	(1,078)
Cash and cash equivalents acquired with subsidiary undertakings	27	33	2
Purchase of equity accounted investments	27	(1)	(12)
Proceeds from sale of subsidiary undertakings	9	2	131
Cash and cash equivalents disposed of with subsidiary undertakings		–	(60)
Proceeds from sale of equity accounted investments	9	70	16
Net proceeds from (purchase)/sale of other deposits/securities		(209)	164
Net cash outflow from investing activities		(808)	(1,095)
Capital element of finance lease rental payments		(13)	(18)
Proceeds from issue of share capital		5	16
Purchase of own shares		(25)	(43)
Equity dividends paid	28	(534)	(478)
Dividends paid to minority interests		(5)	(11)
Cash inflow/(outflow) from matured derivative financial instruments		36	(440)
Cash (outflow)/inflow from movement in cash collateral		(11)	106
Cash inflow from loans		920	–
Cash outflow from repayment of loans		(133)	(306)
Net cash inflow/(outflow) from financing activities		240	(1,174)
Net increase/(decrease) in cash and cash equivalents		1,062	(775)
Cash and cash equivalents at 1 January		2,605	3,046
Effect of foreign exchange rate changes on cash and cash equivalents		11	334
Cash and cash equivalents at 31 December		3,678	2,605
Comprising			
Cash and cash equivalents		3,693	2,624
Overdrafts		(15)	(19)
Cash and cash equivalents at 31 December		3,678	2,605

NOTES TO THE GROUP ACCOUNTS

1. Accounting policies

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

Basis of preparation

The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis as discussed in the Directors' report on page 84 and in accordance with EU endorsed International Financial Reporting Standards (IFRS), International Financial Reporting Interpretations Committee interpretations (IFRICs) and the Companies Act 2006 applicable to companies reporting under IFRS.

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

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

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

- the determination of the revenue recognition approach to apply to individual contracts,
- the classification of financial assets or liabilities,
- the classification of retirement benefit plans between defined benefit and defined contribution arrangements, and
- the classification of investments as subsidiaries, equity accounted investments or otherwise.

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

An analysis and explanation of the critical accounting estimates and judgements used in producing this set of financial statements is made in the Directors' report on page 37.

Basis of consolidation

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

Subsidiaries

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

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired, and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Previously held identifiable assets, liabilities

and contingent liabilities of the acquired entity are revalued to their fair value at the date of acquisition, being the date at which the Group achieves control of the acquiree. The movement in fair value is taken to the asset revaluation reserve.

Minority interests

Upon initial acquisition of a minority interest, the interest of minority shareholders is measured at the minority's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised.

Equity accounted investments

An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. Joint ventures are accounted for under the equity method where the Group's income statement includes its share of their profits and losses, and the Group's balance sheet includes its share of their net assets.

Intangible assets

Goodwill

Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill arising on acquisitions before the date of transition to IFRS (1 January 2004) has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entity if it had applied IAS 38, *Intangible Assets*, at the date it was acquired by the Group were considered immaterial, after being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Research and development

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

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses. Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy.

Other intangible assets

Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing or maintaining computer software programmes for sale is recognised as an expense as incurred.

1. Accounting policies continued

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The most significant intangible assets recognised by the Group on businesses acquired to date are in relation to programmes. For programme-related intangibles, amortisation is set on a programme-by-programme basis over the life of the individual programme. Amortisation for customer-related intangibles is also set on an individual basis.

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

The estimated useful lives are as follows:

Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Trademarks and licences	up to 20 years
Capitalised research and development expenditure	up to 10 years
Programme and customer related	up to 15 years
Other intangibles	up to 10 years

Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

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

Buildings	up to 50 years, or the lease term if shorter
Research equipment	8 years
Computing equipment, motor vehicles and short-life works equipment	3 to 5 years
Aircraft	up to 15 years, or the lease term if shorter
Other equipment	10 to 15 years, or the project life if shorter

For certain items of plant and equipment in the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

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

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

Impairment

The carrying amounts of the Group's intangible assets, property, plant and equipment, and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, *Impairment of Assets*. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet

available for use, impairment testing is performed annually. All other assets are considered for impairment under the relevant standard.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill and is assessed for impairment as a single asset.

The recoverable amount of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates.

The recoverable amount of other assets is the greater of their fair value less cost to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate.

For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other assets is reversed if there has been a change in the estimate used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

Investment property

Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Other investments

The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

- 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;
- 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;
- 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;
- available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value.

NOTES TO THE GROUP ACCOUNTS CONTINUED

1. Accounting policies continued

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as at fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

Inventories

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

Trade and other receivables

Trade and other receivables are stated at their amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

An impairment loss is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to company performance, as cash received on customers' account.

Cash received on customers' account is excluded from net cash/(debt) as defined by the Group.

Derivative financial instruments and hedging activities

The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting

treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

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

Cash flow hedges

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

Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call deposits and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Trade and other payables

Trade and other payables are stated at their cost.

Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

1. Accounting policies continued

Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Pension obligations

Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

For defined benefit retirement plans, the cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of comprehensive income. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period until the benefits become vested. Curtailments due to the material reduction of the expected years of future services of current employees or the elimination of the accrual of defined benefits for some or all of the future services for a significant number of employees are recognised immediately as a gain or loss in the income statement.

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

Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Share-based payment compensation

The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2, *Share-based Payment*, the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 25, equity-settled share options are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the number of shares that will actually vest.

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences, including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments, are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Revenue and profit recognition

Sales include the Group's net share of sales of equity accounted investments. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of equity accounted investments.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11, *Construction Contracts*. Sales are recognised when the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

1. Accounting policies *continued*

Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

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

Lease Income

Rental income from aircraft operating leases is recognised in revenue on a straight-line basis over the term of the relevant lease. Lease incentives granted are charged to the income statement over the term of the lease.

Leases

Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

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

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

Underlying EBITA

Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as Underlying EBITA. In order to ensure that it continues to provide a measure of profitability that is comparable over time, it has been amended to exclude all non-recurring items. Underlying EBITA continues to be the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 3 on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality, nature and function. The non-recurring items for the current and prior years are presented on the face of the Group's consolidated income statement.

Finance costs

Financial income comprises interest income on funds invested, gains on the disposal of available-for-sale financial assets, changes in the fair value of financial assets at fair value through profit or loss, and gains on hedging instruments that are recognised in profit or loss.

Financial costs comprise interest expense on borrowings, unwinding of the discounts on provisions, changes in the fair value of financial assets at fair value through profit or loss, and losses on hedging instruments that are recognised in profit or loss.

Borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) are capitalised as part of the cost of that asset, until such time as the assets are ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

No borrowing costs were capitalised in the year ended 31 December 2009.

Dividends

Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

2. Changes in accounting policies

With effect from 1 January 2008, the Group early adopted IFRS 8, *Operating segments*. The standard is concerned with disclosure only.

Standards, amendments and interpretations effective in 2009

With effect from 1 January 2009, the Group has adopted the following amendments to existing standards and interpretations:

- IAS 1 (revised 2007), *Presentation of Financial Statements*, requires that the Group presents a 'statement of comprehensive income' and a 'consolidated statement of changes in equity' as primary statements. The standard is concerned with disclosure only and has no impact on the reported results or financial position of the Group.
- IAS 23 (revised 2007), *Borrowing Costs*, requires borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) to be capitalised as part of the cost of that asset. There is no longer an option to immediately expense those borrowing costs. Whilst this represents a change in the Group's accounting policy, application of the revised standard is prospective i.e. applies to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. This has not had an impact on the reported results or financial position of the Group.
- Amendment to IFRS 7, *Financial Instruments: Disclosures*, requires enhanced disclosures about fair value measurement and liquidity risk. The amendment requires disclosure of fair value measurements by reference to a fair value measurement hierarchy. The amendment is concerned with disclosure only and has no impact on the reported results or financial position of the Group.
- Amendment to IFRS 2, *Share-based Payment: Vesting Conditions and Cancellations*, provides clarification on the vesting conditions which should be included in the grant date fair value for transactions with employees and others providing similar services. This has had no impact on the reported results or financial position of the Group, and
- *Improvements to IFRSs 2008*, the first standard issued under the International Accounting Standards Board's annual improvement process. It amends 20 existing standards, basis of conclusions and guidance. The improvements include changes in presentation, recognition and measurement requirements and have had no significant impact on the reported results or financial position of the Group.

In addition, the Group has reviewed the effect of the following amendments and interpretations endorsed during 2009 and effective for accounting periods beginning on or after 1 January 2009, and has concluded that they have no impact on the Group's accounts:

- Amendments to IAS 32, *Financial Instruments: Presentation*, and IAS 1, *Presentation of Financial Statements: Puttable Financial Instruments and Obligations Arising on Liquidation*,
- Amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosures: Reclassification of Financial Assets*,
- Amendments to IFRS 1, *First-time Adoption of IFRS*, and IAS 27, *Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*,
- Amendments to International Financial Reporting Interpretations Committee (IFRIC) 9, *Reassessment of Embedded Derivatives*, and IAS 39, *Financial Instruments: Recognition and Measurement: Embedded Derivatives*,
- IFRIC 12, *Service Concession Arrangements*,

- IFRIC 13, *Customer Loyalty Programmes*,
- IFRIC 14, IAS 19, *Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*,
- IFRIC 15, *Agreements for the Construction of Real Estate*, and
- IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*.

Amendments to existing standards and interpretations that are not yet effective and have not been early adopted by the Group

The following EU endorsed amendments and interpretations to published standards are effective for accounting periods beginning on or after 1 July 2009, and have not been early adopted by the Group:

- IFRS 3 (revised 2008), *Business Combinations*, introduces some significant changes in the accounting treatment for acquisitions. The most significant change for the Group will be the requirement to expense all acquisition-related costs. The impact on the Group's reported results will be dependent on the specific transaction, and
- Amendments to IAS 27, *Consolidated and Separate Financial Statements: Changes in non-controlling interest with no change in control*. The amendment requires that acquisitions of minority interests that do not result in a change of control are accounted for as transactions with equity holders and therefore no goodwill is recognised as a result of such transactions. The potential impact on the Group's accounts will be dependent on the specific transaction.

The Group has reviewed the effect of the following amendments and interpretations effective for accounting periods beginning on or after 1 July 2009 and does not expect them to have an impact on the Group's accounts:

- Amendment to IAS 39, *Financial Instruments: Recognition and Measurement on Eligible Hedged Items*,
- IFRIC 17, *Distributions of Non-cash Assets to Owners*, and
- IFRIC 18, *Transfers of Assets from Customers*.

The following EU endorsed amendments to published standards are effective for accounting periods beginning on or after 1 January 2010, but have not been early adopted by the Group:

- Amendment to IAS 32, *Financial Instruments: Presentation: Classification of Rights Issues*.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

3. Segmental analysis

The Group has five reportable segments which are organised around a combination of the different products and services they provide and the geographical areas in which they operate

- **Electronics, Intelligence & Support**, based primarily in the US, designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications. It comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions,
- **Land & Armaments**, based primarily in the US, designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products,
- **Programmes & Support** primarily comprises the Group's UK-based air, naval and security activities,
- **International** comprises the Group's businesses in Saudi Arabia and Australia, and its interests in the pan-European MBDA joint venture, Saab of Sweden and Air Astana, and
- **HQ & Other Businesses** comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management

The Group has not aggregated any segments in arriving at the analysis

Management monitors the results of these operating groups to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on underlying 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

	Combined sales of Group and equity accounted investments		Less sales by equity accounted investments		Add sales to equity accounted investments		Revenue	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Electronics, Intelligence & Support	5,637	4,459	–	–	–	–	5,637	4,459
Land & Armaments	6,738	6,407	(6)	(1)	–	1	6,732	6,407
Programmes & Support	6,298	4,638	(1,779)	(1,531)	1,166	983	5,685	4,090
International	4,253	3,333	(1,513)	(1,446)	–	–	2,740	1,887
HQ & Other Businesses	254	235	–	–	–	–	254	235
	23,180	19,072	(3,298)	(2,978)	1,166	984	21,048	17,078
Intra-operating group sales/revenue	(765)	(529)	16	25	75	97	(674)	(407)
	22,415	18,543	(3,282)	(2,953)	1,241	1,081	20,374	16,671

	Intra-operating group revenue		Revenue from external customers	
	2009 £m	2008 £m	2009 £m	2008 £m
Electronics, Intelligence & Support	138	94	5,499	4,365
Land & Armaments	45	30	6,687	6,377
Programmes & Support	431	248	5,254	3,842
International	12	11	2,728	1,876
HQ & Other Businesses	48	24	206	211
	674	407	20,374	16,671

	Capital expenditure ²		Depreciation and amortisation ²	
	2009 £m	2008 £m	2009 £m	2008 £m
Electronics, Intelligence & Support	123	105	125	104
Land & Armaments	84	98	244	227
Programmes & Support	109	85	116	92
International	142	212	55	46
HQ & Other Businesses	64	52	64	69
	522	552	604	538

¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see the Financial review on page 30)

² Includes intangible assets, property, plant and equipment, and investment property

3. Segmental analysis continued

	Underlying EBITA ¹		Non-recurring items ²		Amortisation of intangible assets		Impairment of intangible assets ³		Operating group result ⁴	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Electronics, Intelligence & Support	575	506	202	61	(27)	(24)	(8)	–	742	543
Land & Armaments	604	566	59	–	(177)	(168)	(927)	(40)	(441)	358
Programmes & Support	670	491	68	177	(49)	(24)	(34)	(5)	655	639
International	442	435	–	–	(32)	(30)	(4)	(120)	406	285
HQ & Other Businesses	(71)	(101)	(278)	–	(1)	(1)	–	(12)	(350)	(114)
	2,220	1,897	51	238	(286)	(247)	(973)	(177)	1,012	1,711
Financial (expense)/income of equity accounted investments									(7)	44
Taxation expense of equity accounted investments									(23)	(37)
Operating profit									982	1,718
Finance costs									(700)	653
Profit before taxation									282	2,371
Taxation expense									(327)	(603)
(Loss)/profit for the year									(45)	1,768

	Assets excluding intangible assets and equity accounted investments		Intangible assets		Equity accounted investments		Total assets		Total liabilities	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Electronics, Intelligence & Support	1,827	1,954	5,082	5,272	5	4	6,914	7,230	(1,366)	(1,470)
Land & Armaments	2,030	2,019	4,082	5,712	(4)	–	6,108	7,731	(1,482)	(1,505)
Programmes & Support	1,485	866	1,616	875	47	217	3,148	1,958	(4,611)	(3,506)
International	1,622	1,899	457	429	798	813	2,877	3,141	(1,921)	(1,933)
HQ & Other Businesses	825	1,690	16	18	–	–	841	1,708	(2,624)	(3,035)
	7,789	8,428	11,253	12,306	846	1,034	19,888	21,768	(12,004)	(11,449)
Tax							1,534	1,040	(684)	(784)
Retirement benefit obligations as defined by the Group (note 21)							42	40	(4,452)	(3,365)
Cash/(debt) as defined by the Group (note 27)							3,943	2,827	(3,540)	(2,788)
Consolidated total assets/(liabilities)							25,407	25,675	(20,680)	(18,386)

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see the Financial review on page 30)

2 Non-recurring items comprise profit on disposal of businesses of £68m (2008 £238m) pension curtailment gains of £261m (2008 £nil) and regulatory penalties of £278m (2008 £nil)

3 See note 11

4 The analysis by operating group of the share of results of equity accounted investments is provided in note 14

Analysis of non-current assets by geographical location

Asset location	Carrying value of non-current assets	
	2009 £m	2008 £m
United Kingdom	2,534	1,774
Rest of Europe	1,190	1,272
Saudi Arabia	729	704
United States	9,838	11,703
Asia and Pacific	589	554
Africa, Central and South America	47	22
Non-current operating group assets	14,927	16,029
Financial instruments	310	985
Inventories	887	926
Trade and other receivables	3,764	3,828
Total operating group assets	19,888	21,768

NOTES TO THE GROUP ACCOUNTS *CONTINUED***3. Segmental analysis** *continued***Analysis of sales and revenue by geographical location**

Customer location	Sales		Revenue	
	2009 £m	2008 £m	2009 £m	2008 £m
United Kingdom	4,181	3,398	3,562	2,908
Rest of Europe	2,765	2,647	1,811	1,633
Saudi Arabia	2,780	1,626	2,607	1,538
Rest of Middle East	138	130	64	87
United States	10,941	9,417	10,902	9,401
Canada	127	129	119	125
Asia and Pacific	1,000	808	898	692
Africa, Central and South America	483	388	411	287
	22,415	18,543	20,374	16,671

Analysis of revenue by category

	2009 £m	2008 £m
Sale of goods	6,777	6,042
Construction contracts	10,274	8,176
Services	3,239	2,376
Lease income	73	68
Royalty income	11	9
	20,374	16,671

Analysis of revenue by major customer

Revenue from the Group's three principal customers is as follows

	2009 £m	2008 £m
UK Ministry of Defence	4,101	3,669
US Department of Defense	8,381	7,094
Kingdom of Saudi Arabia Ministry of Defence and Aviation	2,602	1,531

Revenue from the UK Ministry of Defence amounted to £4,101m (2008 £3,669m). Revenue from the US Department of Defense was £8,381m (2008 £7,094m) and is also from all four principal operating groups. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was £2,602m (2008 £1,531m) from sales by the Electronics, Intelligence & Support and International operating groups.

4. Operating costs

	2009 £m	2008 £m
Raw materials and other bought-in items	9,330	7,809
Change in inventories of finished goods and work-in-progress	(538)	(1,395)
Cost of inventories expensed	8,792	6,414
Staff costs (note 7)	5,605	4,618
Depreciation, amortisation and impairment	1,600	634
Loss on disposal of property, plant and equipment	–	1
Regulatory penalties ¹	278	–
Other operating charges	3,785	3,719
	20,060	15,386
Included within the analysis of operating costs are the following expenses		
Lease and sublease payments		
Minimum lease payments	167	151
Research and development expense including amounts funded under contract	1,153	1,044

1 The regulatory penalties of £278m in 2009 reflect the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3

Costs of rationalisation programmes included in operating costs

	2009 £m	2008 £m
Electronics, Intelligence & Support	24	7
Land & Armaments	32	19
Programmes & Support	80	52
International	9	4
HQ & Other Businesses	6	5
	151	87

Fees payable to the Company's auditor and its associates included in operating costs

	2009			2008		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	1,486	–	1,486	1,333	–	1,333
Fees payable to the Company's auditor and its associates for other services						
The audit of the Company's subsidiaries pursuant to legislation*	2,497	4,217	6,714	2,178	3,576	5,754
Other services pursuant to legislation						
Interim review	581	–	581	543	–	543
Other	57	–	57	81	–	81
Further assurance services						
Advice on accounting matters	–	22	22	19	3	22
Internal controls	–	2	2	39	–	39
Due diligence	437	45	482	795	–	795
Tax services						
Compliance	481	768	1,249	392	1,112	1,504
Advisory	272	542	814	490	547	1,037
Other services	175	2	177	–	–	–
Total fees payable to the Company's auditor and its associates	5,986	5,598	11,584	5,870	5,238	11,108

* Total fees payable to the Company's auditor and its associates for audit services

8,200 7,087

The increase in audit fees relating to overseas subsidiaries primarily reflects exchange translation

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world. The majority of services provided outside the UK were provided in the US.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***5. Other income**

	2009 £m	2008 £m
Rental income from operating leases (including from investment property)	50	47
Profit on disposal of investment property	–	5
Profit on disposal of property, plant and equipment	17	34
Profit on disposal of businesses (note 9)	68	238
Management recharges to equity accounted investments (note 31)	24	17
Pension curtailment gains (note 21)	261	–
Other	45	74
	465	415

6. Finance costs

	2009 £m	2008 £m
Interest income	66	147
Net present value adjustments	5	3
Expected return on pension scheme assets (note 21)	777	846
Net gain on remeasurement of financial instruments	408	681
Foreign exchange gains	317	1,703
Financial income	1,573	3,380
Interest expense		
On bank loans and overdrafts	(1)	(2)
On finance leases	(2)	(5)
On bonds and other financial instruments	(225)	(253)
	(228)	(260)
Facility fees	(4)	(4)
Net present value adjustments	(40)	(30)
Interest charge on pension scheme liabilities (note 21)	(900)	(795)
Net loss on remeasurement of financial instruments at fair value through profit or loss	(467)	(917)
Foreign exchange losses	(634)	(721)
Financial expense	(2,273)	(2,727)
Net finance costs	(700)	653

Additional analysis of finance costs

	2009 £m	2008 £m
Net finance costs – Group	(700)	653
Net finance costs – share of equity accounted investments	(7)	44
	(707)	697
Analysed as		
Net interest		
Interest income	66	147
Interest expense	(228)	(260)
Facility fees	(4)	(4)
Net present value adjustments	(35)	(27)
Share of equity accounted investments	6	42
	(195)	(102)
Other finance costs		
Group		
Net financing (charge)/credit on pensions	(123)	51
Market value and foreign exchange movements on financial instruments and investments ¹	(376)	746
Share of equity accounted investments	(13)	2
	(707)	697

1 The loss in 2009 (2008 gain) primarily reflects net foreign exchange movements on the unhedged portion of an intercompany loan from the UK to the US businesses

7. Employees and directors

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows

	Weekly average		At year end	
	2009 Number '000	2008 Number '000	2009 Number '000	2008 Number '000
Electronics, Intelligence & Support	33	32	32	34
Land & Armaments	21	21	20	21
Programmes & Support	27	26	33	26
International	11	9	11	11
HQ & Other Businesses	2	2	2	2
	94	90	98	94

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were

	2009 £m	2008 £m
Wages and salaries ¹	4,897	4,053
Social security costs	400	324
Share options granted to directors and employees – equity-settled	13	18
Share options granted to directors and employees – cash-settled	(2)	(23)
Pension costs – defined contribution plans (note 21)	127	84
Pension costs – defined benefit plans (note 21) ²	167	160
US healthcare plans (note 21)	3	2
	5,605	4,618

1. On a like-for-like basis, after excluding the impact of exchange translation, and acquisitions and disposals, wages and salaries increased by 3% per employee on 2008

2. Excluded £21m of past service credit included within other income in 2008 (note 5)

The Group considers key management personnel as defined under IAS 24, *Related Party Disclosures*, to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 90 to 111. Total emoluments for directors and other key management personnel were

	2009 £'000	2008 £'000
Short-term employee benefits	14,761	14,954
Post-employment benefits ³	1,754	1,339
Termination benefits	-	237
Share-based payment	4,773	5,142
	21,288	21,672

3. 2009 includes special incentive awards (see page 110)

NOTES TO THE GROUP ACCOUNTS *CONTINUED***8. Tax****Taxation expense**

	2009 £m	2008 £m
Current taxation expense		
UK corporation tax		
Current tax	(88)	(357)
Double tax relief	8	7
Adjustment in respect of prior years	(44)	19
	(124)	(331)
Overseas tax charges		
Current year	(300)	(241)
Adjustment in respect of prior years	46	23
	(254)	(218)
	(378)	(549)
Deferred taxation expense		
UK		
Origination and reversal of temporary differences	3	(58)
Adjustment in respect of prior years	16	38
Overseas		
Origination and reversal of temporary differences	55	(47)
Adjustment in respect of prior years	(23)	13
	51	(54)
Taxation expense	(327)	(603)

Reconciliation of taxation expense

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements

	2009 £m	2008 £m
Profit before taxation	282	2,371
UK corporation tax rate	28.0%	28.5%
Expected income tax expense	(79)	(676)
Effect of tax rates in foreign jurisdictions	(37)	(45)
Expenses not tax effected	(43)	(40)
Income not subject to tax	32	55
Research and development tax credits	36	5
Goodwill impairment	(203)	(15)
Chargeable gains	(1)	(5)
Utilisation of previously unrecognised tax losses	6	74
Current year losses not tax effected	(7)	(9)
Adjustments in respect of prior years	(5)	93
Adjustments in respect of equity accounted investments	57	6
Regulatory penalties	(78)	–
Other	(5)	(46)
Taxation expense	(327)	(603)

8. Tax continued

Tax recognised in other comprehensive income

	2009			2008		
	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	(246)	–	(246)	807	–	807
Equity accounted investments	(56)	–	(56)	197	–	197
Amounts (charged)/credited to hedging reserve	(393)	110	(283)	469	(130)	339
Gain on revaluation of step acquisition	103	(29)	74	–	–	–
Net actuarial losses on defined benefit pension schemes						
Subsidiaries	(2,008)	541	(1,467)	(1,937)	634	(1,303)
Equity accounted investments	(54)	16	(38)	(60)	17	(43)
Recycling of cumulative currency translation on disposal	–	–	–	1	–	1
Share-based payments	–	(2)	(2)	–	(24)	(24)
Fair value movements on available-for-sale investments	2	–	2	–	–	–
Other	–	6	6	–	3	3
	(2,652)	642	(2,010)	(523)	500	(23)

Current tax taken in equity

	2009 £m	2008 £m
Relating to financial instruments	(3)	2
Relating to share-based payments	2	2
Relating to pensions	53	54
Other	12	–
	64	58

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Property, plant and equipment	1	1	(52)	(70)	(51)	(69)
Intangible assets	–	–	(325)	(509)	(325)	(509)
Provisions and accruals	431	459	–	(2)	431	457
Goodwill	–	–	(69)	(34)	(69)	(34)
Pension/retirement plans						
Deficits	1,430	1,115	–	–	1,430	1,115
Additional contributions	15	66	–	–	15	66
Share-based payments	24	30	–	–	24	30
Financial instruments	–	–	(4)	(136)	(4)	(136)
Other items	53	42	(6)	(17)	47	25
Rolled over capital gains	–	–	(18)	(18)	(18)	(18)
Capital losses carried forward	18	18	–	–	18	18
Trading losses carried forward	14	1	–	–	14	1
Unremitted overseas dividends	–	–	(3)	–	(3)	–
Deferred tax assets/(liabilities)	1,986	1,732	(477)	(786)	1,509	946
Set off of tax	(469)	(706)	469	706	–	–
Net deferred tax assets/(liabilities)	1,517	1,026	(8)	(80)	1,509	946

NOTES TO THE GROUP ACCOUNTS CONTINUED

8. Tax continued

Movement in temporary differences during the year

	At 1 January 2009 £m	Exchange movements £m	Acquisitions and disposals ¹ £m	Other movements £m	Recognised in income £m	Recognised in equity £m	At 31 December 2009 £m
Property, plant and equipment	(69)	6	(4)	–	16	–	(51)
Intangible assets	(509)	33	(34)	–	214	(29)	(325)
Provisions and accruals	457	(23)	17	–	(20)	–	431
Goodwill	(34)	5	–	–	(40)	–	(69)
Pension/retirement plans							
Deficits	1,115	(45)	–	–	(164)	524	1,430
Additional contributions	66	–	(3)	–	(12)	(36)	15
Share-based payments	30	(1)	–	–	(1)	(4)	24
Financial instruments	(136)	–	–	–	19	113	(4)
Other items	25	–	(5)	–	33	(6)	47
Rolled over capital gains	(18)	–	–	–	–	–	(18)
Capital losses carried forward	18	–	–	–	–	–	18
Trading losses carried forward	1	1	3	–	9	–	14
Unremitted overseas dividends	–	–	–	–	(3)	–	(3)
	946	(24)	(26)	–	51	562	1,509

1 Acquisitions and disposals includes deferred tax assets on the acquisition of Tenix Defence (£7m) and Detica (£4m) less deferred tax liabilities arising on the acquisition of the remaining shareholding in BVT (£35m)

	At 1 January 2008 £m	Exchange movements £m	Acquisitions and disposals ² £m	Other movements £m	Recognised in income £m	Recognised in equity £m	At 31 December 2008 £m
Property, plant and equipment	(70)	(17)	(2)	–	20	–	(69)
Intangible assets	(372)	(116)	(67)	–	46	–	(509)
Provisions and accruals	269	92	45	1	50	–	457
Goodwill	(25)	(9)	28	–	(28)	–	(34)
Pension/retirement plans							
Deficits	522	115	(35)	1	(98)	610	1,115
Additional contributions	106	–	4	–	(14)	(30)	66
Share-based payments	75	4	–	–	(23)	(26)	30
Financial instruments	6	–	–	–	(10)	(132)	(136)
Other items	9	(2)	3	1	11	3	25
Rolled over capital gains	(18)	–	–	–	–	–	(18)
Capital losses carried forward	18	–	–	–	–	–	18
Trading losses carried forward	7	–	2	–	(8)	–	1
	527	67	(22)	3	(54)	425	946

2 Acquisitions and disposals includes deferred tax assets on the acquisition of MTC (£16m) and Tenix Defence (£9m) and the finalisation of fair values relating to the Armor Holdings Inc acquisition in 2007 (£7m) less deferred tax liabilities on the acquisition of Detica (£23m) and the deferred tax asset transferred on formation of the BVT joint venture (£31m)

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items

	2009 £m	2008 £m
Deductible temporary differences	10	23
Capital losses carried forward	58	58
Trading and other losses carried forward	158	90
	226	171

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time

Due to changes in UK tax legislation during the year, there are no unrecognised deferred tax liabilities arising on the aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures (2008 £332m) Any withholding tax due on the remittance of future earnings is expected to be insignificant

9. Disposals

Continuing operations for the year ended 31 December 2009

Profit on disposal of businesses of £68m comprises the finalisation of the accounting gain recognised in 2008 on the disposal of the Group's interests in the businesses contributed to the BVT joint venture following acquisition of VT Group's 45% interest in 2009 (£58m) and additional proceeds received in respect of the disposal in 2008 of the Group's interest in Flagship Training (£10m)

The Group received deferred consideration of £72m in the year ended 31 December 2009 in respect of the disposals of Flagship Training Limited in 2008 (£70m) and the Inertial Products business in 2007 (£2m) (note 27)

Continuing and discontinued operations for the year ended 31 December 2008

Name	Country of incorporation	Date of sale	Percentage share	Profit on disposal of businesses £m	Proceeds from sale of subsidiary undertakings £m	Proceeds from sale of equity accounted investments £m	Deferred consideration £m
Surveillance & Attack division	USA	22 02 08	100%	61	118	–	–
BAE Systems Surface Fleet Solutions Limited ¹	UK	01 07 08	45%	121	–	–	–
Flagship Training Limited ²	UK	01 07 08	50%	56	–	16	53
Gregory backpack business	USA	14 03 08	100%	–	7	–	–
Continuing operations				238	125	16	53
Discontinued operations ³ – Mobile International business	USA	14 02 08	100%	–	6	–	–
				238	131	16	53

¹ On 1 July 2008, the Group exchanged a 45% shareholding in BAE Systems Surface Fleet Solutions Limited (SFSL) as consideration for the contribution to SFSL of 100% of VT Group plc's shipbuilding and naval support businesses to form the joint venture BVT Surface Fleet Limited

² Discounted consideration of £67m had been deferred over three years, the discounted value of which was £53m and is included within other receivables at 31 December 2008

³ The Group's Mobile International business was acquired with Armor Holdings, Inc. on 31 July 2007 with a view to immediate resale. Accordingly, it was classified as held for sale as at 31 December 2007. The sale was completed on 14 February 2008 for a cash consideration less transaction costs of £6m

10. Earnings per share

	2009			2008		
	£m	Basic pence per share	Diluted pence per share	£m	Basic pence per share	Diluted pence per share
(Loss)/profit for the year attributable to equity shareholders	(67)	(1.9)	(1.9)	1,745	49.6	49.5
Add back/(deduct)						
Profit on disposal of businesses, post tax	(65)			(208)		
Pension curtailment gains, post tax	(188)			–		
Regulatory penalties	278			–		
Net financing charge/(credit) on pensions, post tax	91			(39)		
Market value movements on derivatives, post tax	278			(552)		
Amortisation and impairment of intangible assets, post tax	384			184		
Impairment of goodwill – subsidiaries	725			54		
Impairment of goodwill – equity accounted investments	–			121		
Underlying earnings, post tax	1,436	40.7	40.6	1,305	37.1	37.0
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		3,532	3,532		3,519	3,519
Incremental shares in respect of employee share schemes			4			9
Weighted average number of shares used in calculating diluted earnings per share			3,536			3,528

Underlying earnings per share is presented in addition to that required by IAS 33, *Earnings per Share*, to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

In the 12 months to 31 December 2009, outstanding share options were anti-dilutive and so have been excluded from the diluted loss per share in accordance with IAS 33.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***11. Intangible assets**

	Goodwill £m	Programme and customer related ¹ £m	Other ² £m	Total £m
Cost or valuation				
At 1 January 2008	10,661	1,180	271	12,112
Additions				
Acquired separately	–	–	30	30
Internally developed	–	–	2	2
Acquisition of subsidiaries (note 29)	903	144	69	1,116
Adjustment on finalisation of provisional goodwill ⁴	6	–	–	6
Disposals	(251)	–	(15)	(266)
Asset reclassifications	–	–	5	5
Exchange adjustments	1,882	404	55	2,341
At 31 December 2008	13,201	1,728	417	15,346
Additions				
Acquired separately	–	–	28	28
Internally developed	–	–	14	14
Reclassification from equity accounted investments (note 14) ⁵	253	–	–	253
Acquisition of subsidiaries (note 29)	367	225	–	592
Adjustment on finalisation of provisional goodwill ⁴	5	11	–	16
Disposals	–	–	(7)	(7)
Transfer from property, plant and equipment	–	–	4	4
Exchange adjustments	(655)	(144)	(8)	(807)
At 31 December 2009	13,171	1,820	448	15,439
Amortisation and impairment				
At 1 January 2008	2,213	253	87	2,553
Disposals	(59)	–	(11)	(70)
Amortisation charge ³	–	199	48	247
Impairment charge	54	–	2	56
Asset reclassifications	–	–	3	3
Exchange adjustments	125	104	22	251
At 31 December 2008	2,333	556	151	3,040
Disposals	–	–	(7)	(7)
Amortisation charge ³	–	219	67	286
Impairment charge	725	240	8	973
Exchange adjustments	(55)	(48)	(3)	(106)
At 31 December 2009	3,003	967	216	4,186
Net book value				
At 31 December 2009	10,168	853	232	11,253
At 31 December 2008	10,868	1,172	266	12,306
At 1 January 2008	8,448	927	184	9,559

¹ Relates to intangible assets recognised on acquisition of subsidiary companies mainly in respect of ongoing programme relationships and the acquired order book

² Other intangibles includes patents, trademarks, software and internally funded development costs

³ Amortisation is included in operating costs in the income statement

⁴ Adjustment on finalisation of provisional goodwill relating to the acquisition of MTC Technologies, Inc., Tenix Defence Holdings Pty Limited, Tenix Toll Defence Logistics Pty Limited, Detica Group Plc and IST Dynamics in 2008 and Amor Holdings, Inc. in 2007. The amounts are not considered material for the restatement of comparative information.

⁵ Goodwill arising on the formation of the BVT joint venture in the year ended 31 December 2008 and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited has been reclassified from equity accounted investments to intangible assets in accordance with IFRS 3 *Business Combinations* in 2009 upon acquisition of VT Group's 45% shareholding in the BVT joint venture.

The Group has no indefinite life intangible assets other than goodwill. The Group's approach to goodwill impairment testing is set out in the accounting policies on page 125.

Impairment testing

The Group's goodwill of £10.2bn (2008 £10.9bn) is allocated across 23 cash-generating units (CGUs). In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances have been considered with regard to value in use calculations. These calculations use risk-adjusted future cash flow projections based on the Group's five-year Integrated Business Plan (IBP) and include a terminal value based on the projections for the final year of that plan, with an inflationary growth rate assumption applied. The IBP process uses historic experience, available government spending data and the Group's order book. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.72% (adjusted for risks specific to the market in which the CGU operates), have been used in discounting these projected risk-adjusted cash flows.

11. Intangible assets *continued*

Significant CGUs

The Group has three CGUs with allocated goodwill which is significant in comparison with the total carrying amount of goodwill. These are the US-based electronic warfare, network and mission solutions business in the Electronics, Intelligence & Support (EI&S) operating group (£2.6bn), and the US-based ex-United Defense Industries, Inc. (UDI) (£2.0bn) and ex-Armor Holdings, Inc. (Armor) (£1.7bn pre-impairment below) businesses in the Land & Armaments operating group. The key assumptions underpinning the cash flow projections for the EI&S CGU are the continuing demand from the US government for electronic warfare systems, mission solutions and other technology-based solutions, and from non-military agencies for network solutions. The key assumptions underpinning the cash flow projections for the Land & Armaments CGUs are the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support. The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.9%, 9.8% and 10.3%, respectively. The growth rate assumption applied to the final year of these projections was 3% (2% for Armor), reduced from 4% in the prior year reflecting increased uncertainty in the US defence budgets.

Whilst there are no other CGUs with allocated goodwill balances exceeding 15% of the Group's total goodwill balance, the majority of the projected cash flows within the remaining CGUs are underpinned by the expected continuation of levels of government spending on aerospace, defence and security, and the Group's ability to capture a broadly consistent market share.

The directors have not identified any reasonably possible material changes relating either specifically to the global military vehicle market, or to the levels of defence spending in the Group's home markets, particularly in the US, that would cause the carrying value of goodwill to exceed its recoverable amount.

Impairment – goodwill

The total goodwill impairment charge of £725m mainly arises in three of the CGUs, Armor (£526m), Products Group, acquired as part of the Armor transaction in 2007 (£156m), and Detica (£34m).

The Armor impairment charge reflects both the non-award of a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme and the subsequent impact on the growth prospects of the business.

The Products Group impairment charge reflects a weaker outlook for the business as spending from customer discretionary budgets has reduced in both domestic and export markets. The pre-tax discount rate used was 9.5%.

The Detica impairment charge relates to the discontinued financial services element of the business. The pre-tax discount rate used was 10.0%.

Impairment – intangible assets

The total intangible assets impairment charge of £248m comprises £240m relating to programme and customer related intangibles, and £8m relating to other intangibles. The charge impacts the EI&S (£8m), Land & Armaments (£236m) and International (£4m) operating groups.

The charge relating to Land & Armaments includes £108m in respect of the Products Group business, £66m relating to the FMTV non-award and a number of individually small items each calculated on a programme-by-programme basis.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***12. Property, plant and equipment**

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2008	1,386	2,095	602	4,083
Additions	269	209	42	520
Acquisition of subsidiaries (note 29)	40	72	-	112
Transfers from inventories	2	-	-	2
Reclassification between categories	5	(5)	-	-
Disposals	(15)	(69)	(12)	(96)
Disposal of subsidiaries	(46)	(76)	-	(122)
Exchange adjustments	331	303	194	828
At 31 December 2008	1,972	2,529	826	5,327
Additions	245	187	48	480
Acquisition of subsidiaries (note 29)	85	53	-	138
Transfers from inventories	-	2	-	2
Transfer to investment properties	(2)	-	-	(2)
Transfer to other intangible assets	-	(4)	-	(4)
Reclassification between categories	28	(28)	-	-
Disposals	(23)	(78)	(43)	(144)
Exchange adjustments	(110)	(110)	(72)	(292)
At 31 December 2009	2,195	2,551	759	5,505
Depreciation and impairment				
At 1 January 2008	494	1,426	389	2,309
Depreciation charge for the year	68	167	55	290
Impairment charge for the year	2	29	9	40
Reclassification between categories	(3)	3	-	-
Disposals	(14)	(63)	(3)	(80)
Disposal of subsidiaries	(17)	(42)	-	(59)
Exchange adjustments	75	170	136	381
At 31 December 2008	605	1,690	586	2,881
Depreciation charge for the year	80	184	51	315
Impairment charge for the year	11	2	10	23
Reclassification between categories	(5)	5	-	-
Disposals	(20)	(73)	(32)	(125)
Exchange adjustments	(27)	(63)	(51)	(141)
At 31 December 2009	644	1,745	564	2,953
Net book value				
Freehold property	1,313	-	-	1,313
Long leasehold property	185	-	-	185
Short leasehold property	53	-	-	53
Plant and machinery	-	697	-	697
Fixtures, fittings and equipment	-	109	-	109
Aircraft	-	-	195	195
At 31 December 2009	1,551	806	195	2,552
At 31 December 2008	1,367	839	240	2,446
At 1 January 2008	892	669	213	1,774

Impairment

The impairment charge of £23m in 2009 mainly comprises charges in respect of aircraft carrying values within the Regional Aircraft business (£8m) and a £13m charge following the reassessment of the carrying value of certain assets within the International operating group. The impairment impacts the International (£13m), HQ & Other Businesses (£8m) and Land & Armaments (£2m) segments.

The impairment in 2008 mainly comprises charges in respect of the spares and support business, and aircraft carrying values within the Regional Aircraft business (£32m). The impairment impacts the HQ & Other Businesses (£36m), Programmes and Support (£3m) and International (£1m) segments.

12. Property, plant and equipment *continued*

Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Assets in the course of construction (including investment property (note 13))				
At 31 December 2009	133	76	–	209
At 31 December 2008	355	107	–	462

Finance leases

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Net book value of assets held as capitalised finance leases				
At 31 December 2009	–	–	5	5
At 31 December 2008	–	–	23	23

At 31 December 2009, none of the assets held under finance leases are sublet under operating leases (2008 £15m)

Operating leases

The aircraft fleet that is held under capitalised finance lease arrangements is leased to airline companies under operating leases. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	2009 £m	2008 £m
Receipts due		
Not later than one year	78	104
Later than one year and not later than five years	201	241
Later than five years	23	62
	302	407

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations. Within the above lease income is £nil (2008 £17m) relating to assets held by the Group under capitalised finance leases.

13. Investment property

	£m
Cost	
At 1 January 2008	158
Disposals	(5)
At 31 December 2008	153
Transfer from property, plant and equipment	2
At 31 December 2009	155
Depreciation and impairment	
At 1 January 2008	45
Depreciation charge for the year	1
Disposals	(5)
At 31 December 2008	41
Depreciation charge for the year	3
At 31 December 2009	44
Net book value of investment property	
At 31 December 2009	111
At 31 December 2008	112
At 1 January 2008	113
Fair value of investment property	
At 31 December 2009	166
At 31 December 2008	149

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification and with recent experience in valuing properties in the location and the type of property being valued.

	2009 £m	2008 £m
Rental income from investment property	20	21

NOTES TO THE GROUP ACCOUNTS *CONTINUED***14. Equity accounted investments****Carrying value of equity accounted investments**

	Share of net assets £m	Purchased goodwill £m	Carrying value £m
At 1 January 2008	321	460	781
Share of results after tax – continuing operations	139	–	139
Acquired	12	178	190
Adjustment on finalisation of provisional goodwill	(48)	48	–
Disposal	(13)	(4)	(17)
Impairment	–	(121)	(121)
Dividends	(89)	–	(89)
Market value adjustments in respect of derivative financial instruments, net of tax	(7)	–	(7)
Actuarial losses on defined benefit pension schemes, net of tax	(43)	–	(43)
Reclassified from trade and other receivables	4	–	4
Foreign exchange adjustment	98	99	197
At 31 December 2008	374	660	1,034
Share of results after tax – continuing operations	203	–	203
Disposal	28	–	28
Reclassification to intangible assets (note 11)	–	(253)	(253)
Dividends	(77)	–	(77)
Market value adjustments in respect of derivative financial instruments, net of tax	5	–	5
Actuarial losses on defined benefit pension schemes, net of tax	(38)	–	(38)
Foreign exchange adjustment	(31)	(25)	(56)
At 31 December 2009	464	382	846

On 30 October 2009, the BVT Surface Fleet Limited (BVT) joint venture became a wholly-owned subsidiary of the Group after VT Group plc (VT) exercised its option to sell its 45% shareholding in BVT to BAE Systems (note 29). As part of the transaction, the Group's shareholding in Fleet Support Limited also increased to 100% (2008 55%). On the date of the transaction, the Group gained full control of BVT, which was previously jointly controlled with VT.

From 1 January 2009 to the date of completion, the Group equity accounted the results of BVT to reflect the Group's 55% interest held. From the date of completion, the results and net assets of BVT, renamed BAE Systems Surface Ships Limited, have been consolidated in the Group's accounts as a wholly-owned subsidiary.

Goodwill of £225m arising on the formation of the BVT joint venture, comprising £177m on the initial formation of the joint venture and £48m reflecting adjustments to the provisional fair values assigned to the net assets acquired, and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited (£28m), has been reclassified to intangible assets (note 11) in accordance with IFRS 3, *Business Combinations*.

Included within purchased goodwill is £89m (2008 £94m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

The market value of the Group's shareholding in Saab AB at 31 December 2009 was £229m (2008 £140m).

Share of results of equity accounted investments by operating group

	2009 £m	2008 £m
Share of results excluding finance costs and taxation expense		
Electronics, Intelligence & Support	1	–
Land & Armaments	(3)	–
Programmes & Support	77	44
International	158	88
	233	132
Financial (expense)/income	(7)	44
Taxation expense	(23)	(37)
	203	139

Share of the assets and liabilities of equity accounted investments

	2009 £m	2008 £m
Assets		
Non-current assets	990	1,308
Current assets	3,313	3,768
	4,303	5,076
Liabilities		
Non-current liabilities	(678)	(807)
Current liabilities	(2,779)	(3,235)
	(3,457)	(4,042)
Carrying value	846	1,034

14. Equity accounted investments *continued*

Contingent liabilities

The Group is exposed to actual and contingent liabilities arising from commercial aircraft financing and RVGs given by Saab AB. Provision is made against the expected net exposures on a net present value basis within the accounts of Saab. The Group's share of such exposure is limited to its percentage shareholding in Saab.

The Group is not aware of any other material contingent liabilities in respect of equity accounted investments.

Principal equity accounted investments

Joint ventures	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
Eurofighter Jagdflugzeug GmbH (Held by BAE Systems plc)	Management and control of the Typhoon programme	33% ordinary	Germany	Germany
MBDA SAS (Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)	Development and manufacture of guided weapons	37.5% ordinary	Europe	France
Saab AB (Held via BAE Systems (Sweden) AB)	Defence and commercial aerospace activities	20.5% Series A&B	Sweden	Sweden

The Group comprises a large number of equity accounted investments and it is not practical to include all of them in the above list. The list therefore only includes those equity accounted investments which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2009 will be annexed to the Company's next annual return filed with the Registrar of Companies.

15. Other investments

	2009 £m	2008 £m
Non-current		
Available-for-sale financial assets		
Equity securities	6	6
	6	6
Current		
Available-for-sale financial assets		
Government bonds ¹	211	–
	211	–
Reconciliation of movements		
	2009 £m	2008 £m
Non-current		
At 1 January and 31 December	6	6
Current		
At 1 January	–	164
Additions	209	–
Disposals	–	(164)
Fair value movements	2	–
At 31 December	211	–

¹ The £211m government bonds at 31 December 2009 are held in a Reservoir Trust in respect of the Group's UK pension schemes (see the Financial review on page 33).

NOTES TO THE GROUP ACCOUNTS *CONTINUED***16. Trade and other receivables**

	2009 £m	2008 £m
Non-current		
Other receivables	156	122
Pension prepayment (note 21)	42	37
Prepayments and accrued income	3	3
	201	162
Current		
Long-term contract balances	7,034	6,215
Less attributable progress payments	(5,941)	(5,410)
Amounts due from contract customers	482	484
Amounts due from customers for contract work ¹	1,575	1,289
Trade receivables	1,452	1,653
Amounts owed by equity accounted investments (note 31)	207	200
Other receivables	274	426
Pension prepayment (note 21)	-	3
Prepayments and accrued income	256	260
	3,764	3,831

1 There are no retentions against long term contracts (2008 £nil) and no amounts that are past due within amounts due from customers for contract work (2008 £nil)

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2009 are estimated to be £36 9bn (2008 £35 7bn)

The ageing of trade receivables is detailed below

	2009			2008		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	1,194	-	1,194	1,176	-	1,176
Not past due and impaired	-	-	-	2	(2)	-
Up to 180 days overdue and not impaired	233	-	233	175	-	175
Up to 180 days overdue and impaired	9	(2)	7	15	(15)	-
Past 180 days overdue and not impaired	18	-	18	302	-	302
Past 180 days overdue and impaired	45	(45)	-	33	(33)	-
	1,499	(47)	1,452	1,703	(50)	1,653

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows

	2009 £m	2008 £m
At 1 January	50	53
Created	36	32
Released	(27)	(37)
Exchange adjustments	(2)	7
Acquisitions	2	-
Utilised	(12)	(5)
At 31 December	47	50

The other classes within trade and other receivables do not contain assets which are considered to be impaired

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk.

17. Other financial assets and liabilities

	2009 Assets £m	2009 Liabilities £m	2008 Assets £m	2008 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	100	(95)	309	(100)
Other foreign exchange/interest rate contracts	6	(166)	2	(283)
Debt-related derivative financial instruments – assets ¹	27	–	203	–
	133	(261)	514	(383)
Current				
Cash flow hedges – foreign exchange contracts	158	(54)	502	(237)
Other foreign exchange/interest rate contracts	46	(40)	172	(88)
Fair value of put option held by VT Group plc	–	–	–	(37)
Debt-related derivative financial instruments – assets ²	12	–	–	–
	216	(94)	674	(362)

¹ Includes fair value hedges of £26m (2008 £55m)

² Includes fair value hedges of £12m (2008 £nil)

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (note 19)

The notional principal amounts of the outstanding contracts are detailed in note 30

Cash flow hedges

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts debited to the hedging reserve in respect of cash flow hedges were £393m (2008 credit £469m)

The amount reclassified from equity to the income statement was £nil (2008 £nil). The amount debited from equity and included in non-financial assets was £39m (2008 £32m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £nil (2008 £nil).

Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £20m (2008 £37m gain). The gain arising in the income statement on the fair value of the underlying hedged items was £20m (2008 £38m loss). The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £4m (2008 £3m).

18. Inventories

	2009 £m	2008 £m
Short-term work-in-progress	451	424
Raw materials and consumables	312	370
Finished goods and goods for resale	124	132
	887	926

The Group recognised £35m (2008 £46m) as a write down of inventories to net realisable value in 2009.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

19. Loans and overdrafts

	2009 £m	2008 £m
Non-current		
US\$500m 4 75% bond, repayable 2010	–	361
US\$1bn 6 4% bond, repayable 2011	645	728
Class B and Class G certificates, final instalments 2011/2013	379	547
Euro-Sterling £100m 10¾% bond, repayable 2014	100	100
US\$500m 4 95% bond, repayable 2014	308	–
US\$750m 5 2% bond, repayable 2015	463	516
Albertville Hangar Bond, repayable 2018	6	7
US\$1bn 6 375% bond, repayable 2019	608	–
US\$500m 7 5% bond, repayable 2027	307	341
Obligations under finance leases	1	8
Debt-related derivative financial instruments – liabilities	23	–
	2,840	2,608
Current		
Bank loans and overdrafts	15	35
European Investment Bank loan, final instalment 2009	–	4
Alvis loan notes, redeemable 2009	–	1
US\$500m 4 75% bond, repayable 2010	322	–
Class B and Class G certificates, final instalment 2011/2013	110	121
Obligations under finance leases	6	12
	453	173

The maturity of the Group's borrowings is as follows

	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
At 31 December 2009				
Carrying amount ¹	453	1,453	1,387	3,293
Debt-related derivative financial instruments – assets	(12)	(26)	(1)	(39)
Carrying amount including debt-related derivative financial instruments – assets	441	1,427	1,386	3,254
Contractual cash flows, including future interest payments	583	1,849	1,890	4,322
At 31 December 2008				
Carrying amount ¹	173	1,644	964	2,781
Debt-related derivative financial instruments – assets	–	(87)	(116)	(203)
Carrying amount including debt-related derivative financial instruments – assets	173	1,557	848	2,578
Contractual cash flows, including future interest payments	292	1,881	1,314	3,487

1 The carrying amount of loans and overdrafts at 31 December 2009 excludes debt related derivative financial assets of £39m (2008 £203m) presented as other financial assets

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

The US\$500m 4 75% bond, repayable 2010, was converted on issue to a floating rate bond by utilising interest rate swaps giving an effective rate during 2009 of 1.96%.

The US\$1bn 6 4% bond, repayable 2011, has been partially converted to a floating rate bond by utilising a series of interest rate swaps. US\$500m has been swapped to a floating rate until maturity of the bond in 2011. This has been overlaid by US\$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2009 was 5.29% with an interest rate split on the bond at 31 December 2009 being US\$800m fixed and US\$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013, respectively, with fixed US\$ coupon rates of 7.16% and 6.66%, giving a weighted average interest rate of 6.88%. At 31 December 2009, the gross outstanding principal due is US\$772m. Of this balance, US\$235m has been converted to a sterling floating rate bond by utilising a series of cross-currency swaps and interest rate swaps which resulted in an effective interest rate during 2009 of 2.84% on this element.

In 2009, two US bonds were issued with the following maturities, US\$500m 4 95% bond, repayable 2014 and US\$1bn 6 375% bond, repayable 2019. The US\$500m 4 95% bond was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2009 of 1.08%. US\$500m of the US\$1bn 6 375% bond has been partially converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and give an effective rate during 2009 of 6.1%.

The Albertville Hangar Bond is a floating rate bond with an effective interest rate of 3.06%. This bond has been converted to a fixed rate using a floating to fixed rate swap, fixing the rate at 3.52%.

The US\$500m 7 5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

19. Loans and overdrafts *continued*

The debt-related derivative financial instruments represent the fair value of certain interest rate and cross-currency derivatives which are hedging specific loans disclosed within the above note, the US\$500m 4.75% bond, repayable 2010, the US\$1bn 6.4% bond, repayable 2011, Class B and G certificates, final instalments 2011/2013, the US\$1bn 6.375% bond, repayable 2019, and the US\$500m 7.5% bond repayable 2027. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Finance lease obligations

The Group has a number of non-cancellable finance lease arrangements predominantly in respect of aircraft. The maturity of these lease liabilities from the balance sheet date is shown below.

	2009 £m	2008 £m
Finance lease liabilities – minimum lease payments due		
Not later than one year	7	13
Later than one year and not later than five years	1	9
	8	22
Future finance charges on finance leases	(1)	(2)
Present value of finance lease liabilities	7	20
Present value of finance lease liabilities – payments due		
Not later than one year	6	12
Later than one year and not later than five years	1	8
	7	20

Under the terms of the lease agreements, no contingent rents are payable.

The average interest rate on finance lease payables at 31 December 2009 was 5% (2008 7%).

20. Trade and other payables

	2009 £m	2008 £m
Non-current		
Amounts due to long-term contract customers	142	275
Cash received on customers' account ¹ for long-term contracts	5	–
Other payables	332	329
Accruals and deferred income	43	97
	522	701
Current		
Amounts due to long-term contract customers	5,533	4,494
Amounts due to other customers	216	348
Cash received on customers' account ¹		
Long-term contracts	14	5
Others	1	2
Trade payables	1,063	1,004
Amounts owed to equity accounted investments (note 31)	1,353	1,476
Other taxes and social security costs	51	67
Other payables ²	851	400
Accruals and deferred income	1,136	1,369
	10,218	9,165
Included above		
	2009 £m	2008 £m
Amounts due to long-term contract customers	5,694	4,774
Advances from long-term contract customers, including progress payments in respect of work not yet performed	5,416	4,501

¹ Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance.

² Other payables includes the regulatory penalties of £278m in 2009 reflecting the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3.

NOTES TO THE GROUP ACCOUNTS CONTINUED

21. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19, *Employee Benefits*, deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries and updated to take account of the requirements of IAS 19 in order to assess the deficit of the plans at 31 December each year. Plan assets are shown at the bid value at 31 December each year.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2009. These plans were rolled forward to reflect the information at 31 December 2009. The method of accounting for these is similar to that used for defined benefit pension plans.

The financial assumptions used to calculate liabilities for the principal plans are

	UK			US		
	2009 %	2008 %	2007 %	2009 %	2008 %	2007 %
Inflation rate	3.5	2.9	3.3	3.0	3.0	3.0
Rate of increase in salaries	4.5	3.9	4.3	4.5	5.5	5.8
Rate of increase for pensions in payment	2.3 – 3.7	2.2 – 3.4	2.3 – 3.3	–	–	–
Rate of increase for deferred pensions	3.5	2.9	3.3	n/a	n/a	n/a
Discount rate	5.7	6.3	5.8	5.9	6.5	6.5
Long-term healthcare cost increases	n/a	n/a	n/a	5.3	5.3	5.4

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid value of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of plan liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, as at 31 December are shown in the tables below.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2009, continued to use PA 00 medium cohort tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of plan members. In addition, this mortality has been subject to a minimum assumed rate of future annual mortality improvements of 1%. For its US pension arrangements, the mortality tables used for pensioners and non-pensioners are RP 2000 projected to 2010. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 19 to 23 years for current male pensioners at age 65 and 22 to 25 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 9% in 2009 reducing to 5% by 2015 for pre-retirement and 10% in 2009 reducing to 5% for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Additional disclosure – summary of movements of the retirement benefit obligations

	UK £m	US and other £m	Total £m
Deficit in defined benefit pension plans at 1 January 2009	(3,072)	(1,083)	(4,155)
Actual return on assets above expected return	994	264	1,258
Increase in liabilities due to changes in assumptions	(3,120)	(222)	(3,342)
One-off contributions	85	160	245
Recurring contributions in excess of service cost	244	(14)	230
Past service cost	(18)	(3)	(21)
Curtailment gains	–	261	261
Net financing charge	(119)	(26)	(145)
Exchange translation	–	96	96
Deficit in defined benefit pension plans at 31 December 2009	(5,006)	(567)	(5,573)
US healthcare plans	–	(43)	(43)
Total IAS 19 deficit	(5,006)	(610)	(5,616)
Allocated to equity accounted investments and other participating employers	979	–	979
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers	(4,027)	(610)	(4,637)

21. Retirement benefit obligations *continued*

The increase in the liabilities due to changes in assumptions is primarily due to a fall in corporate bond yields combined with an increase in the expected inflation rate which have combined to reduce the real discount rates used to calculate the liabilities of the pension plans as at 31 December 2009

The curtailment gain recognised in the year relates to pension benefit restructuring in the US

During the year, the Group contributed £225m into Trust for the benefit of the Group's main pension scheme. The contribution is reported within other investments – current (£211m after a fair value gain of £2m) and cash and cash equivalents (£16m) in the consolidated balance sheet at 31 December 2009, and the use of these assets is restricted under the terms of the Trust. However, the Group considers this contribution to be equivalent to the other one-off contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit to include this contribution

	31 December 2009 £m
Group's share of IAS 19 deficit	(4,637)
Assets held in Trust	227
Pension deficit as defined by the Group	(4,410)

Amounts recognised on the balance sheet

	2009				2008			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	(10)	(115)	(11)	(136)	(10)	(132)	(11)	(153)
Present value of funded obligations	(17,776)	(2,587)	(140)	(20,503)	(14,221)	(2,770)	(142)	(17,133)
Fair value of plan assets	12,780	2,135	108	15,023	11,159	1,819	92	13,070
Total IAS 19 deficit, net	(5,006)	(567)	(43)	(5,616)	(3,072)	(1,083)	(61)	(4,216)
Allocated to equity accounted investments and other participating employers	979	–	–	979	891	–	–	891
Group's share of IAS 19 deficit, net	(4,027)	(567)	(43)	(4,637)	(2,181)	(1,083)	(61)	(3,325)
Represented by								
Pension prepayments (within trade and other receivables)	–	42	–	42	–	25	15	40
Retirement benefit obligations	(4,027)	(609)	(43)	(4,679)	(2,181)	(1,108)	(76)	(3,365)
	(4,027)	(567)	(43)	(4,637)	(2,181)	(1,083)	(61)	(3,325)

Group's share of IAS 19 deficit of equity accounted investments	(128)	–	–	(128)	(168)	–	–	(168)
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Amounts for the current and previous four years are as follows

Defined benefit pension plans	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Defined benefit obligations	(20,488)	(17,133)	(17,109)	(17,456)	(17,767)
Plan assets at bid value	14,915	12,978	15,110	14,289	12,461
Total deficit before tax and allocation to equity accounted investments and other participating employers	(5,573)	(4,155)	(1,999)	(3,167)	(5,306)
Actuarial (loss)/gain on plan liabilities	(3,342)	1,433	952	473	(2,100)
Actuarial gain/(loss) on plan assets at bid value	1,258	(3,724)	(156)	521	1,138

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £3.4bn (2008 £1.4bn)

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during the year ended 31 December 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

NOTES TO THE GROUP ACCOUNTS CONTINUED

21. Retirement benefit obligations continued

Assets of defined benefit pension plans

	2009							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,195	64	8.25	1,384	65	9.25	9,579	64
Bonds	3,411	27	4.8	551	26	6.0	3,962	27
Property	960	7	6.0	101	5	7.0	1,061	7
Other	214	2	1.0	99	4	4.0	313	2
Total	12,780	100	7.0	2,135	100	8.1	14,915	100

	2008							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	6,964	62	8.25	1,110	61	9.25	8,074	62
Bonds	3,170	28	5.1	441	24	6.0	3,611	28
Property	846	8	6.0	193	11	7.0	1,039	8
Other	179	2	2.0	75	4	5.0	254	2
Total	11,159	100	7.1	1,819	100	8.07	12,978	100

When setting the overall expected rate of return on plan assets, historical markets are studied and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2008	13,192	1,918	95	15,205
Assets acquired on acquisitions ¹	99	—	—	99
Expected return on assets	901	165	8	1,074
Actuarial loss	(2,956)	(768)	(39)	(3,763)
Actual return on assets	(2,055)	(603)	(31)	(2,689)
Contributions by employer	425	61	8	494
Contributions by employer in respect of employee salary sacrifice arrangements	112	—	—	112
Total contributions by employer	537	61	8	606
Members' contributions (including Department for Work and Pensions rebates)	42	11	—	53
Currency gain	—	533	25	558
Benefits paid	(656)	(101)	(5)	(762)
Value of plan assets at 31 December 2008	11,159	1,819	92	13,070
Expected return on assets	765	141	6	912
Actuarial gain	994	264	13	1,271
Actual return on assets	1,759	405	19	2,183
Contributions by employer	421	216	13	650
Contributions by employer in respect of employee salary sacrifice arrangements	107	—	—	107
Total contributions by employer	528	216	13	757
Members' contributions (including Department for Work and Pensions rebates)	36	18	—	54
Currency loss	—	(198)	(10)	(208)
Benefits paid	(702)	(125)	(6)	(833)
Value of plan assets at 31 December 2009	12,780	2,135	108	15,023

¹ Acquired on formation of the BVT Surface Fleet Limited joint venture

21. Retirement benefit obligations *continued*

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2008	(15,100)	(2,009)	(116)	(17,225)
Net liabilities assumed on acquisitions ¹	(107)	–	–	(107)
Current service cost	(109)	(56)	(2)	(167)
Contributions by employer in respect of employee salary sacrifice arrangements	(112)	–	–	(112)
Total current service cost	(221)	(56)	(2)	(279)
Members' contributions (including Department for Work and Pensions rebates)	(42)	(11)	–	(53)
Past service cost	(23)	21	–	(2)
Actuarial gain/(loss) on liabilities	1,471	(38)	8	1,441
Interest expense	(865)	(137)	(8)	(1,010)
Currency loss	–	(773)	(40)	(813)
Benefits paid	656	101	5	762
Defined benefit obligations at 31 December 2008	(14,231)	(2,902)	(153)	(17,286)
Current service cost	(92)	(70)	(3)	(165)
Contributions by employer in respect of employee salary sacrifice arrangements	(107)	–	–	(107)
Total current service cost	(199)	(70)	(3)	(272)
Members' contributions (including Department for Work and Pensions rebates)	(36)	(18)	–	(54)
Past service cost	(18)	(3)	–	(21)
Actuarial loss on liabilities	(3,120)	(222)	(8)	(3,350)
Curtailment gains	–	261	–	261
Interest expense	(884)	(167)	(9)	(1,060)
Currency gain	–	294	16	310
Benefits paid	702	125	6	833
Defined benefit obligations at 31 December 2009	(17,786)	(2,702)	(151)	(20,639)

1. Acquired on formation of the BVT Surface Fleet Limited joint venture

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2009 were £546m (2008 £399m) excluding those amounts allocated to equity accounted investments and participating employers (£91m). This includes an incremental contribution of \$250m (£160m) which the Group made to the US pension schemes during the year. In 2010, the Group expects to make regular contributions at a similar level to those made in 2009.

The Group incurred a charge in respect of the cash contributions of £127m (2008 £84m) paid to defined contribution plans for employees. It expects to make a contribution of £141m to these plans in 2010.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***21. Retirement benefit obligations** *continued*

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2009				2008			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs								
Current service cost	(80)	(70)	(3)	(153)	(83)	(56)	(2)	(141)
Past service cost	(14)	(3)	–	(17)	(21)	–	–	(21)
	(94)	(73)	(3)	(170)	(104)	(56)	(2)	(162)
Included in other income								
Past service credit	–	–	–	–	–	21	–	21
Curtailment gains	–	261	–	261	–	–	–	–
	–	261	–	261	–	21	–	21
Included in finance costs								
Expected return on plan assets	630	141	6	777	673	165	8	846
Interest on obligations	(724)	(167)	(9)	(900)	(650)	(137)	(8)	(795)
	(94)	(26)	(3)	(123)	23	28	–	51
Included in share of results of equity accounted investments								
Group's share of equity accounted investments' operating costs	(9)	–	–	(9)	(8)	–	–	(8)
Group's share of equity accounted investments' finance costs	(3)	–	–	(3)	2	–	–	2

A one percentage point change in assumed healthcare cost trend rates would have the following effects

	One percentage point increase £m	One percentage point decrease £m
(Increase)/decrease in the aggregate of service cost and interest cost	(0.2)	0.1
(Increase)/decrease in defined benefit obligations	(2.1)	1.7

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Decrease/(increase) in defined benefit obligations	1.6	(1.6)

22. Provisions

	Aircraft financing £m	Warranties and after sales service £m	Reorganisations – continuing operations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	30	104	10	238	77	459
Current	41	68	58	148	71	386
At 1 January 2009	71	172	68	386	148	845
Created	1	89	133	168	48	439
Released	–	(53)	(10)	(68)	(29)	(160)
Utilised	(37)	(51)	(44)	(61)	(16)	(209)
Provisions and fair values arising on acquisitions (note 29)	–	8	–	4	–	12
Discounting	4	–	–	16	5	25
Exchange adjustments	(1)	(2)	–	(13)	(7)	(23)
At 31 December 2009	38	163	147	432	149	929
Represented by						
Non-current	20	99	21	169	68	377
Current	18	64	126	263	81	552
	38	163	147	432	149	929

Aircraft financing

The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. The Group has provided residual value guarantees in respect of certain commercial aircraft sold. At 31 December 2009, the Group's gross exposure to make future payments in respect of these arrangements was £48m (2008 £97m). The Group's net exposure to these guarantees is covered by the provisions held of £32m (2008 £58m) and the residual values of the related aircraft of £12m (2008 £37m). Such costs are generally incurred within five years.

Warranties and after-sales service

Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. Such costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum but not the timing of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations – continuing operations

The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

Legal, contractual and environmental provisions

The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period.

These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

Other provisions

There are no individually significant provisions included within other provisions.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***23. Contingent liabilities and commitments****Guarantees and performance bonds**

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

Operating lease commitments – where the Group is the lessee

The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2009 £m	2008 £m
Payments due		
Not later than one year	180	177
Later than one year and not later than five years	571	546
Later than five years	704	679
	1,455	1,402
Total of future minimum sublease income under non-cancellable subleases	286	259

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2009 £m	2008 £m
Property, plant and equipment	126	133
Intangible assets	7	7
	133	140

24. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2 5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2008	3,574	90	1	1	90
Exercise of options	8	~	—	—	—
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	~	—	—	—
At 31 December 2009	3,585	90	1	1	90

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares

As at 31 December 2009, 43,952,360 (2008 55,038,953) ordinary shares of 2 5p each with an aggregate nominal value of £1,098,809 (2008 £1,375,974) were held in treasury. During 2009, 11,086,593 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme.

Authorised share capital

As agreed by the shareholders at the 2009 Annual General Meeting, the Company's Articles of Association were amended with effect from 1 October 2009 to remove the requirement for the Company to have an authorised share capital, the concept of which was abolished under the Companies Act 2006.

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Total £m
At 1 January 2009	4,589	202	—	787	396	5,974
Total recognised income and expense	—	—	74	(302)	(283)	(511)
At 31 December 2009	4,589	202	74	485	113	5,463

Merger reserve

The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

Statutory reserve

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

Revaluation reserve

The revaluation reserve relates to the revaluation at fair value of the net assets previously held as an equity accounted investment relating to the BVT joint venture on the acquisition of the remaining 45% interest in 2009.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***24. Share capital and other reserves** *continued***BAE Systems ESOP Trust**

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2009.

At 31 December 2009, the ESOP held 3,644,598 (2008 2,093,818) ordinary shares of 2.5p each with a market value of £13m (2008 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2009 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and December 2009 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Capital

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

At 31 December 2009, the Group's capital was £4,614m (2008 £6,893m), which comprises total equity of £4,727m (2008 £7,289m), less amounts accumulated in equity relating to cash flow hedges of £113m (2008 £396m). Net cash as defined by the Group was £403m (2008 £39m).

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

25. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 90 to 111.

Executive Share Option Scheme (ExSOS)**Equity-settled options**

	2009		2008	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	23,731	3.49	31,728	3.33
Exercised during the year	(1,931)	2.40	(6,921)	2.67
Expired during the year	(3,570)	4.14	(1,076)	4.19
Outstanding at the end of the year	18,230	3.48	23,731	3.49
Exercisable at the end of the year	13,506	3.09	13,628	2.78

Cash-settled share appreciation rights

	2009		2008	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	12,667	2.65	16,993	2.67
Exercised during the year	(1,420)	2.15	(3,963)	2.71
Expired during the year	(1,159)	3.54	(363)	2.95
Outstanding at the end of the year	10,088	2.62	12,667	2.65
Exercisable at the end of the year	10,088	2.62	12,522	2.64

	2009		2008	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	1.72 – 4.79	1.72 – 3.98	1.72 – 4.79	2.01 – 4.21
Weighted average remaining contracted life (years)	6	3	6	4
Expense/(credit) recognised for the year (£m)	2	(2)	5	(18)

25. Share-based payments *continued*

Performance Share Plan (PSP)

Equity-settled options

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	20,880	20,952
Granted during the year	12,701	7,507
Exercised during the year	(4,445)	(6,433)
Expired during the year	(2,941)	(1,146)
Outstanding at the end of the year	26,195	20,880
Exercisable at the end of the year	2,212	2,151

Cash-settled options

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	3,143	7,949
Exercised during the year	(2,291)	(4,368)
Expired during the year	(35)	(438)
Outstanding at the end of the year	817	3,143

No options were exercisable at the end of the year

	2009		2008	
	Equity-settled	Cash-settled	Equity-settled	Cash settled
Weighted average remaining contracted life (years)	5	2	5	3
Weighted average fair value of options granted (£)	2.81	–	3.78	–
Expense/(credit) recognised for the year (£m)	8	1	10	(1)

The exercise price for the PSP is £nil (2008 £nil)

Restricted Share Plan (RSP)

All awards are equity settled

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	216	603
Exercised during the year	(216)	(385)
Expired during the year	–	(2)
Outstanding at the end of the year	–	216
Exercisable at the end of the year	–	3
	2009	2008
Weighted average remaining contracted life (years)	–	–
Expense recognised for the year (£m)	–	–

The exercise price for the RSP is £nil (2008 £nil)

Share Matching Plan (SMP)

All awards are equity-settled

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	1,811	463
Granted during the year	7,661	1,470
Exercised during the year	(94)	(110)
Expired during the year	(698)	(12)
Outstanding at the end of the year	8,680	1,811
Exercisable at the end of the year	–	–
	2009	2008
Weighted average remaining contracted life (years)	2	2
Weighted average fair value of options granted (£)	3.43	4.79
Expense recognised for the year (£m)	3	2

The exercise price for the SMP is £nil (2008 £nil)

NOTES TO THE GROUP ACCOUNTS *CONTINUED***25. Share-based payments** *continued***Save-As-You-Earn (SAYE)****Equity-settled options**

	2009		2008	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	4,636	1.56	9,477	1.25
Exercised during the year	(4,550)	1.56	(4,597)	0.94
Expired during the year	(82)	1.54	(244)	1.31
Outstanding at the end of the year	4	1.56	4,636	1.56
Exercisable at the end of the year	4	1.56	94	0.92

Cash-settled share appreciation rights

	2009		2008	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	2,895	3.56	5,154	3.14
Exercised during the year	(349)	3.56	(1,949)	2.46
Expired during the year	(2,546)	3.56	(310)	3.53
Outstanding at the end of the year	–	–	2,895	3.56
Exercisable at the end of the year	–	–	2,895	3.56

	2009		2008	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	1.56	–	0.93 – 1.56	3.85
Weighted average remaining contracted life (years)	–	–	1	–
(Credit)/expense recognised for the year (£m)	–	(1)	1	(4)

Details of options granted in the year

The fair value of both equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models

PSP – Monte Carlo

SMP – Dividend valuation model

	2009	2008
Range of share price at date of grant (£)	3.23 – 3.43	3.48 – 5.05
Exercise price (£)	–	–
Expected option life (years)	3 – 4	3 – 4
Volatility	34%	25 – 32%
Spot dividend yield	4.2 – 4.6%	3.0 – 4.4%
Risk free interest rate	1.7 – 1.8%	2.4 – 3.9%

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date

The average share price in the year was £3.44 (2008 £4.33)

The liability in respect of the cash-settled elements of the schemes shown above and reported within liability provisions at 31 December 2009 is £12m (2008 £26m)

The intrinsic value of cash-settled options that have vested at 31 December 2009 is £10m (2008 £15m)

Share Incentive Plan

The Group also incurred a charge of £31m (2008 £28m) in respect of the all-employee free shares element of the Share Incentive Plan

26. Reconciliation of operating business cash flow

	2009 £m	2008 £m
Cash inflow from operating activities	2,232	2,009
Purchases of property, plant and equipment	(483)	(520)
Purchases of intangible assets	(42)	(32)
Proceeds from the sale of property, plant and equipment	36	44
Proceeds from the sale of investment property	-	5
Dividends received from equity accounted investments	77	89
Assets contributed to Trust	(225)	-
Operating business cash flow	1,595	1,595
Electronics, Intelligence & Support	380	380
Land & Armaments	480	467
Programmes & Support	285	651
International	816	163
HQ & Other Businesses	(366)	(66)
Operating business cash flow	1,595	1,595

NOTES TO THE GROUP ACCOUNTS *CONTINUED***27. Net cash as defined by the Group**

	2009 £m	2008 £m
Debt-related derivative financial instrument assets – current	12	–
Debt-related derivative financial instrument assets – non-current	27	203
Other investments – current	211	–
Cash and cash equivalents	3,693	2,624
	3,943	2,827
Loans – non-current	(2,840)	(2,608)
Loans – current	(438)	(154)
Overdrafts – current	(15)	(19)
Loans and overdrafts – current	(453)	(173)
Cash received on customers' account ¹	(20)	(7)
Assets held in Trust	(227)	–
	(3,540)	(2,788)
Closing net cash as defined by the Group	403	39

Movement in net cash as defined by the Group

	2009 £m	2008 £m
Operating business cash flow	1,595	1,595
Interest	(186)	(98)
Taxation	(350)	(261)
Free cash inflow	1,059	1,236
Acquisitions and disposals	(253)	(1,001)
Debt acquired on acquisition of subsidiary undertakings	(1)	(37)
Proceeds from issue of share capital	5	16
Equity dividends paid	(534)	(478)
Dividends paid to minority interests	(5)	(11)
Purchase of own shares	(25)	(43)
Cash inflow/(outflow) from matured derivative financial instruments	36	(440)
Cash (outflow)/inflow from movement in cash collateral	(11)	106
Other non-cash movements	(157)	339
Foreign exchange	262	(374)
Movement in cash received on customers' account ¹	(12)	26
Movement in net cash as defined by the Group	364	(661)
Opening net cash as defined by the Group	39	700
Closing net cash as defined by the Group	403	39

¹ Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables in the Group's balance sheet.

Cash flows in relation to acquisitions and disposals

	Subsidiaries					Equity accounted investments		
	BVT £m	Advanced Ceramics Research £m	Total acquisitions £m	Inertial Products £m	Total disposals £m	Flagship Training £m	Diamond Detectors £m	Total £m
Cash (consideration)/proceeds	(348)	(9)	(357)	2	2	70	(1)	(286)
Cash and cash equivalents net of overdrafts acquired	33	–	33	–	–	–	–	33
Acquisitions and disposals	(315)	(9)	(324)	2	2	70	(1)	(253)
Debt acquired on acquisition of subsidiary	–	(1)	(1)	–	–	–	–	(1)
	(315)	(10)	(325)	2	2	70	(1)	(254)

28. Dividends

	2009 £m	2008 £m
Equity dividends		
Prior year final 8 7p dividend per ordinary share paid in the year (2008 7 8p)	307	274
Interim 6 4p dividend per ordinary share paid in the year (2008 5 8p)	227	204
	534	478

After the balance sheet date, the directors proposed a final dividend of 9 6p (2008 8 7p). The dividend, which is subject to shareholder approval, will be paid on 1 June 2010 to shareholders registered on 23 April 2010. The ex-dividend date is 21 April 2010.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2010.

29. Acquisition of subsidiaries

Acquisition of subsidiaries for the year ended 31 December 2009

The most significant acquisition made by the Group during the year ended 31 December 2009 was of the 45% shareholding in BVT Surface Fleet Limited (BVT) held by VT Group plc (VT). If the acquisition had occurred on 1 January 2009, combined sales of Group and equity accounted investments would have been £22.8bn, revenue £21.3bn and loss for the year ended 31 December 2009 £58m.

BVT (now BAE Systems Surface Ships)

On 30 October 2009, the BVT joint venture became a wholly-owned subsidiary of the Group after VT Group plc exercised its option to sell its 45% shareholding in BVT to BAE Systems. Consideration paid including transaction costs for the remaining 45% interest was £348m. The now wholly-owned company has been renamed BAE Systems Surface Ships Limited (Surface Ships). The Group previously held a 55% interest in BVT, and accounted for its share of the results and net assets of BVT in accordance with IAS 31, *Interests in Joint Ventures*.

Total provisional goodwill arising amounted to £584m. This consists of £225m which arose on the initial formation of the BVT joint venture in the year ended 31 December 2008 and £359m arising on the acquisition of the 45% interest.

In the period from acquisition to 31 December 2009, Surface Ships contributed revenue and profit after tax of £338m and £34m, respectively, to the Group's consolidated results as a wholly-owned subsidiary.

Surface Ships is a leading designer, manufacturer and integrator of surface ships and their support vessels. It delivers complex engineering, integration and through-life support across the lifecycle of a ship. Bringing Surface Ships into full ownership of BAE Systems further strengthens the Group's global maritime business and is consistent with the strategy to establish a sustainable and profitable through-life business in air, land and sea. Surface Ships has a solid order book, a clear strategy to transform the UK maritime sector and a commitment to deliver existing and future programmes.

The acquisition of BVT had the following effect on the Group's assets and liabilities. The figures in the table below represent a 100% interest in BVT.

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	–	–	225	225
Property, plant and equipment	136	–	–	136
Inventories	61	–	–	61
Receivables	225	–	–	225
Deferred tax assets	2	–	3	5
Payables	(433)	–	(164)	(597)
Current tax liabilities	(16)	–	–	(16)
Deferred tax liabilities	(6)	–	(63)	(69)
Provisions	(12)	–	–	(12)
Cash and cash equivalents	33	–	–	33
Net (liabilities)/assets acquired	(10)	–	1	(9)
Goodwill				584
Fair value of net liabilities acquired and goodwill arising				575

Components of cost of acquisitions

Fair value of consideration for initial 55% shareholding in 2008	189
Fair value of consideration for remaining 45% shareholding in 2009	348
Total cost of acquisition	537
Losses under equity method of initial 55% shareholding	(36)
Gain on revaluation of step acquisition	74
Fair value of net liabilities acquired and goodwill arising	575

Consideration satisfied by:

Cash paid on acquisition of remaining 45% shareholding in 2009	346
Directly attributable costs	
Paid	2
Cash consideration	348
Fair value of net assets contributed to BVT joint venture for initial 55% shareholding in 2008	178
Directly attributable costs	
Paid	11
Total cost of acquisition	537

The intangible assets acquired as part of the acquisition of BVT can be analysed as follows:

	£m
Order backlog	225
	225

NOTES TO THE GROUP ACCOUNTS *CONTINUED***29. Acquisition of subsidiaries *continued*****Advanced Ceramics Research**

The Group acquired Advanced Ceramics Research, Inc. in the US on 8 June 2009 for a consideration of \$14m (£9m). The net assets and goodwill included in the Group's consolidated balance sheet as a result of this acquisition are £1m and £8m, respectively.

Acquisition of subsidiaries for the year ended 31 December 2008

The Group acquired MTC Technologies, Inc. (MTC) in the US on 9 June 2008, Tenix Defence in Australia on 27 June 2008 and Detica Group plc (Detica) on 25 September 2008. If the acquisitions had occurred on 1 January 2008, combined sales of Group and equity accounted investments would have been £19.0bn, revenue £17.2bn and profit for the year ended 31 December 2008 £1.8bn.

MTC

On 9 June 2008, the Group acquired 100% of the issued share capital of MTC in the US for a cash consideration including transaction costs of \$375m (£188m). Goodwill arising on consolidation amounted to £131m.

Based in Dayton, Ohio, MTC provides technical and professional services, and equipment integration and modernisation for the US military and intelligence agencies.

In the period from acquisition to 31 December 2008, MTC contributed revenue and loss after tax of £98m and £1m, respectively, to the Group's consolidated results.

The acquisition of MTC complements the existing US business in the Electronics, Intelligence & Support operating group. It allows for synergies in professional services, aircraft integration centres, and modification and sustainment. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within the Electronics, Intelligence & Support operating group supporting the goodwill.

The MTC acquisition had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	12	–	13	25
Property, plant and equipment	14	(1)	5	18
Inventories	4	–	1	5
Receivables	48	–	–	48
Deferred tax assets	1	–	15	16
Payables	(23)	–	(1)	(24)
Deferred tax liabilities	(4)	–	4	–
Provisions	–	–	(1)	(1)
Cash and cash equivalents	2	–	–	2
Loans	(32)	–	–	(32)
Net assets/(liabilities) acquired	22	(1)	36	57
Goodwill				131
Consideration				188
Consideration satisfied by:				
Cash				184
Directly attributable costs				4
Paid				
				188

The intangible assets acquired as part of the acquisition of MTC can be analysed as follows:

	£m
Customer relationships	21
Technology	4
	25

29. Acquisition of subsidiaries *continued*

Tenix Defence

Tenix Defence Holdings Pty Limited (Tenix Defence), a leading Australian defence contractor, comprises four businesses in the Land, Aerospace, Electronic Systems and Marine sector

On 27 June 2008, the Group acquired 100% of the issued share capital of Tenix Defence for a cash consideration including transaction costs paid of A\$697m (£328m), subject to adjustment according to the level of working capital in the business at the acquisition date

In the period from acquisition to 31 December 2008, Tenix Defence contributed revenue, EBITA¹ and loss after tax of £130m, £12m loss and £39m, respectively, to the Group's consolidated results. Included within the loss after tax of £39m is an amortisation expense on intangible assets of £29m

The acquisition of Tenix Defence complements the existing Australian business enabling BAE Systems to establish a greater presence in the Australian defence market and in particular to expand into the Australian land and marine sectors. These opportunities do not translate into separately identifiable intangible assets, but represent much of the assessed value within Tenix Defence supporting the recognised goodwill

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

The acquisition of Tenix Defence had the following effect on the Group's assets and liabilities

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	5	(2)	91	94
Property, plant and equipment	36	(2)	43	77
Receivables	68	—	—	68
Deferred tax assets	—	—	9	9
Payables	(99)	(21)	(118)	(238)
Provisions	(1)	(3)	1	(3)
Net assets/(liabilities) acquired	9	(28)	26	7
Provisional goodwill				323
Consideration				330
Consideration satisfied by				
Cash				323
Directly attributable costs				
Paid				5
Accrued				2
				330

The fair value adjustment to payables of £118m is in respect of provisions for contract losses

The intangible assets acquired as part of the acquisition of Tenix Defence can be analysed as follows

	£m
Programmes	75
Order backlog	4
Patents	15
	94

NOTES TO THE GROUP ACCOUNTS *CONTINUED***29. Acquisition of subsidiaries** *continued***Detica**

On 25 September 2008, the Group's offer for the acquisition of Detica for £543m including assumption of net debt became wholly unconditional. Detica is a specialist business and technology consultancy with expertise in information exploitation, security and resilience, threat intelligence and customer insight.

In the period from acquisition to 31 December 2008, Detica contributed revenue and profit after tax of £60m (UK £55m) and £1m, respectively, to the Group's consolidated results.

The acquisition of Detica provides access to UK and US government contracting opportunities in the intelligence, security and resilience market and significant cross selling opportunities, particularly in our home markets. The combination of capabilities within Detica and BAE Systems will provide innovative solutions in this growing sector. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within BAE Systems supporting the recognised goodwill.

The acquisition of Detica had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	3	–	91	94
Property, plant and equipment	15	–	–	15
Inventories	2	–	–	2
Receivables	69	–	–	69
Deferred tax assets	2	–	–	2
Payables	(46)	–	–	(46)
Current tax liabilities	–	–	(1)	(1)
Deferred tax liabilities	(1)	–	(24)	(25)
Overdrafts	(4)	–	–	(4)
Loans	(5)	–	–	(5)
Net assets acquired	35	–	66	101
Provisional goodwill				442
Consideration				543
Consideration satisfied by				
Cash				531
Directly attributable costs				12
Paid				543

The intangible assets acquired as part of the acquisition of Detica can be analysed as follows:

	£m
Order backlog	22
Customer relationships	22
Trademarks	30
Software	20
	94

Other acquisitions

Other acquisitions included the acquisitions of 100% of the issued share capital of Tenix Toll Defence Logistics Pty Limited, formerly a joint venture between Tenix and Toll Holdings Pty Limited, for A\$24m (£12m) and 100% of the issued share capital of IST Dynamics for £7m. As a result of these acquisitions, £7m of goodwill was generated in the year ended 31 December 2008.

Certain of the fair values assigned to the net assets at the dates of acquisition were provisional, and in accordance with IFRS 3, *Business Combinations*, the Group has adjusted the fair values attributable to these acquisitions in the year ended 31 December 2009, resulting in a net increase in goodwill of £5m. This has not had a material impact on the consolidated accounts and, as such, the Group has not restated the balance sheet as at 31 December 2008.

30. Financial risk management

A discussion of the Group's treasury objectives and policies and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net cash/(debt) (note 27) together with other financial assets and other financial liabilities (note 17) and other instruments deemed to be financial instruments under IAS 32, *Financial Instruments Presentation*, including non-current receivables, non-current payables and non-current provisions.

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2009				31 December 2008			
	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	(614)	202	53	(359)	(1,199)	248	8	(943)
Euro	1,882	392	17	2,291	2,286	620	4	2,910
Other	44	71	-	115	132	2	-	134
	1,312	665	70	2,047	1,219	870	12	2,101

	31 December 2009				31 December 2008			
	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	310	1,115	-	1,425	-	896	-	896
Sterling	31	115	-	146	33	146	-	179
	341	1,230	-	1,571	33	1,042	-	1,075

	31 December 2009				31 December 2008			
	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	965	310	1,326	58	303	345	706
	51	965	310	1,326	58	303	345	706

Fair value of financial instruments

The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates,
- the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates, and
- the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

NOTES TO THE GROUP ACCOUNTS *CONTINUED***30. Financial risk management *continued***

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date¹

	Net carrying amount 2009 £m	Estimated fair value 2009 £m	Net carrying amount 2008 £m	Estimated fair value 2008 £m
Assets				
Non-current				
Other receivables ²	159	159	125	125
Other financial assets	133	133	514	514
Current				
Available-for-sale investments	211	211	–	–
Other financial assets	216	216	674	674
Cash and cash equivalents	3,693	3,693	2,624	2,624
Liabilities				
Non-current				
Loans	(2,840)	(3,266)	(2,608)	(3,090)
Other financial liabilities	(261)	(261)	(383)	(383)
Current				
Loans and overdrafts	(453)	(454)	(173)	(173)
Other financial liabilities	(94)	(94)	(362)	(362)

1 The estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date

2 Net carrying amount approximates to estimated fair value as there is no active market

Fair value hierarchy

Effective 1 January 2009, the Group adopted the amendment to IFRS 7, *Financial Instruments Disclosures*, for financial instruments that are measured in the balance sheet at fair value. This requires disclosure of fair value measurements by level of the following fair value measurement hierarchy

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities,
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices), and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs)

The following table presents the Group's assets and liabilities that are measured at fair value at 31 December 2009

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Available-for-sale investments	211	–	–	211
Derivatives used for hedging	197	61	–	258
Financial assets at fair value through profit or loss	46	6	–	52
Debt-related derivative financial instruments	–	39	–	39
Total assets	454	106	–	560
Liabilities				
Loans and receivables	–	(1,118)	–	(1,118)
Derivatives used for hedging	(68)	(81)	–	(149)
Financial liabilities at fair value through profit or loss	(43)	(163)	–	(206)
Debt-related derivative financial instruments	–	(23)	–	(23)
Total liabilities	(111)	(1,385)	–	(1,496)

Level 1 includes foreign exchange hedges valued at unadjusted quoted prices at less than two years' maturity. Level 2 includes all other fair value items and foreign exchange hedges greater than two years' maturity.

Interest rate risk

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below

	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	Beyond 2014 £m
Assets						
Current						
Cash and cash equivalents	3,693	–	–	–	–	–
Liabilities						
Non-current						
Loans	(865)	(865)	(714)	(689)	(619)	(310)
Current						
Loans and overdrafts	(349)	–	–	–	–	–

30. Financial risk management *continued*

Collateral

As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2009 totalled £11m (2008 £nil).

Liquidity risk

Cash flow forecasting is performed by each line of business as part of the Integrated Business Planning process and as part of the monthly reporting cycle. The Group monitors a rolling forecast of liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities at all times so that it does not breach borrowing limits or covenants.

Surplus cash held by the operating groups over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in interest bearing current accounts, term deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient headroom as determined by the line of business cash forecasts.

At 31 December 2009, the Group had a committed Revolving Credit Facility (RCF) of £1.455bn (2008 £1.5bn). The £45m commitment in the RCF from Lehman Brothers Commercial Paper Inc. was cancelled during 2009 following an all bank consent process. The RCF is contracted until 2012, although the available amount for the final year reduces to £1.3bn. The RCF remained undrawn throughout the year.

Interest rate risk

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

The Group's current interest rate management policy is that a minimum of 50% (2008 25%) and a maximum of 75% (2008 75%) of debt is maintained at fixed interest rates. At 31 December 2009, the Group had 62% (2008 73%) of fixed rate debt and 38% (2008 27%) of floating rate debt based on a gross debt of £3.3bn including debt-related derivative financial assets (2008 £2.6bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2009, the Group had a total of \$1.9bn (2008 \$1.3bn) of this type of swap outstanding with a weighted average duration of 4.2 years (2008 2.4 years). In respect of the fixed rate debt the weighted average period in respect of which interest is fixed was 6.4 years (2008 7 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.4% (2008 5.2%), 3.0% on US dollars and 2.3% on sterling (2008 3.5% on US dollars and 8% on sterling). The cost of the fixed rate debt was 6.3% (2008 6.8%). A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £12m (2008 £6m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £17m (2008 £12m).

Credit risk

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. The Group has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2009 of £3,693m (2008 £2,624m) was invested with 26 (2008 14) financial institutions. The system assigns a maximum exposure based on the counterparty's size, a composite credit rating and credit default swap price. These limits are regularly monitored and updated. The Group has material receivables due from the UK and US governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 5% of the balance (2008 2%).

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has reduced its exposure to credit risk through this process.

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

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

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

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

NOTES TO THE GROUP ACCOUNTS *CONTINUED***31. Related party transactions**

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 90 to 111 and in note 7), its equity accounted investments (note 14) and the pension plans (note 21)

Transactions occur with the equity accounted investments in the normal course of business and are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below

Related party	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party		Lease income/ (expense) with related party		Management recharges	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
BVT Surface Fleet Limited ¹	64	74	4	1	—	4	—	54	—	—	—	—
Eurofighter Jagdflugzeug GmbH	1,073	889	—	—	132	61	159	221	—	—	—	—
Gripen International KB	1	1	—	—	59	114	98	161	—	—	—	—
MBDA SAS	46	56	302	10	4	9	1,080	1,034	2	—	18	15
Panavia Aircraft GmbH	52	57	103	127	9	11	15	4	—	—	6	2
Saab AB	5	4	17	9	—	1	1	2	—	—	—	—
CTA International SAS	—	—	—	—	3	—	—	—	—	—	—	—
	1,241	1,081	426	147	207	200	1,353	1,476	2	—	24	17

¹ To date of acquisition (30 October 2009)

32. Group entities

Principal subsidiary undertakings	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited (Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)	Defence and commercial aerospace activities	100% Ordinary	UK	England and Wales
BAE Systems Information and Electronic Systems Integration Inc (Held via BAE Systems, Inc)	Designs, develops and manufactures electronic systems and subsystems	100% Common	US	US
BAE Systems Controls Inc (Held via BAE Systems, Inc)	Designs, develops and manufactures military defence electronics equipment	100% Common	US	US
BAE Systems Land & Armaments LP 1300 North 17th Street, Suite 1400, Arlington VA 22209, USA (Partners: BAE Systems Land & Armaments Inc and BAE Systems Land & Armaments Holdings Inc)	Manufactures and supports military vehicles	100%	US	US
Armor Holdings Inc (formerly BAE Systems AH Inc) (Held via BAE Systems, Inc)	Manufactures military vehicles and supplies vehicle and armour systems	100% Common	US	US
BAE Systems Tactical Vehicle Systems LP 5000 Interstate 10 West, Sealy, TX 77474, USA (Partners: BAE Systems TVS Holdings LLC and BAE Systems TVS Inc)	Mobility and protection systems	100%	US	US

The Group comprises a large number of subsidiary undertakings and it is not practical to include all of them in the above list. The list therefore only includes those subsidiary undertakings which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2009 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group consolidation.

33. Events after the balance sheet date

On 5 February 2010, the Group announced a global settlement with the US Department of Justice and the UK's Serious Fraud Office in respect of investigations announced by these two authorities in 2007 and 2004, respectively. This is an adjusting event after the balance sheet date in accordance with IAS 10, *Events after the Reporting Period*, and, accordingly, the penalties totalling £278m have been reflected in the Group's accounts for the year ended 31 December 2009.

On 15 February 2010, the Group announced that it had been informed that the decision by the US Department of Defense not to award a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme to BAE Systems had been confirmed. This is an adjusting event after the balance sheet date in accordance with IAS 10 and, accordingly, impairment of goodwill and other intangible assets amounting to £592m relating to the Armor Holdings, Inc transaction and specifically the FMTV product line have been reflected in the Group's accounts for the year ended 31 December 2009.

COMPANY BALANCE SHEET

as at 31 December

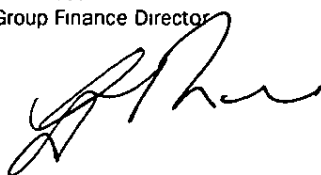
	Notes	2009 £m	2008 Restated £m
Fixed assets			
Tangible assets	2	4	5
Investments in subsidiary undertakings	3	7,070	5,663
		7,074	5,668
Current assets			
Debtors due within one year	4	7,466	9,339
Debtors due after one year	4	14	3
Other financial assets due within one year	5	262	703
Other financial assets due after one year	5	179	478
Cash at bank and in hand		2,804	1,988
		10,725	12,511
Liabilities falling due within one year			
Loans and overdrafts	6	(37)	(49)
Creditors	7	(14,490)	(12,873)
Other financial liabilities	5	(255)	(598)
		(14,782)	(13,520)
Net current liabilities		(4,057)	(1,009)
Total assets less current liabilities		3,017	4,659
Liabilities falling due after one year			
Loans	6	(233)	(258)
Creditors	7	(3)	(6)
Other financial liabilities	5	(327)	(574)
		(563)	(838)
Provisions for liabilities and charges	8	(61)	(120)
		2,393	3,701
Capital and reserves			
Issued share capital	10	90	90
Share premium account	12	1,243	1,238
Statutory reserve	13	202	202
Other reserves	12	119	164
Profit and loss account	12	739	2,007
Equity shareholders' funds		2,393	3,701

Approved by the Board on 17 February 2010 and signed on its behalf by

I G King
Chief Executive



G W Rose
Group Finance Director



NOTES TO THE COMPANY ACCOUNTS CONTINUED

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 are applicable to the Company for the year ended 31 December 2009.

- Amendments to FRS 2, *Accounting for Subsidiary Undertakings*, FRS 6, *Acquisitions and Mergers*, and FRS 28, *Corresponding Amounts*, update references to the Companies Act 2006 and the Large and Medium-sized Companies and Reports Regulations 2008. These amendments have had no impact on the Company.
- Amendments to FRS 8, *Related Party Disclosures*, reflects changes to the law introduced by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. This amendment is effective for accounting periods beginning on or after 6 April 2008. The Company is exempt from presenting FRS 8 disclosures as full equivalent disclosures are presented on a Group basis within the consolidated financial statements.
- Amendments to FRS 20, *Share-based Payment: Vesting Conditions and Cancellations*, provide clarification on the vesting conditions which should be included in the grant date fair value for transactions with employees and others providing similar services. This has had no impact on the Company.
- Amendments to FRS 29, *Financial Instruments: Disclosures*, require enhanced disclosures about fair value measurement and liquidity risk. The amendments require disclosure of fair value measurements by reference to a fair value measurement hierarchy. The Group's consolidated financial statements for the year ended 31 December 2009 contain financial instrument disclosures which are consistent with the requirements of FRS 29, *Financial Instruments: Disclosures*. Consequently, the Company has taken advantage of the exemption in FRS 29 not to present separate financial instrument disclosures for the Company.
- Improvements to Financial Reporting Standards 2008. These improvements have had no impact on the Company.
- Amendments to IUTF Abstract 42 and FRS 26 – *Embedded Derivatives*, clarify the treatment of embedded derivatives and do not impact the Company.
- IUTF Abstract 46, *Hedges of a Net Investment in a Foreign Operation*. This has had no impact on the Company.

The following amendments to existing standards are effective for the year ending 31 December 2010.

- FRS 20, *Share-based Payment – Group Cash-settled Share-based Payment Transactions*,
- FRS 25, *Financial Instruments: Presentation*,
- Amendments to FRS 26, *Financial Instruments: Recognition and Measurement – Eligible Hedged Items*, and
- Improvements to Financial Reporting Standards 2009.

These amendments are not expected to have any impact on the Company's accounts.

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

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

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

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.

1. Accounting policies continued

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.

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.

NOTES TO THE COMPANY ACCOUNTS *CONTINUED***2. Tangible fixed assets**

	Land and buildings £m	Plant and equipment £m	Total £m
Cost			
At 1 January and 31 December 2009	9	27	36
Depreciation and impairment			
At 1 January 2009	6	25	31
Depreciation	–	1	1
At 31 December 2009	6	26	32
Net book value			
At 31 December 2009	3	1	4
At 31 December 2008	3	2	5
	Land and buildings £m	Plant and equipment £m	Total £m
Net book value of:			
Long leasehold property	3	–	3
Fixtures, fittings and equipment	–	1	1
	3	1	4

Land and buildings comprise

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

3. Investments in subsidiary undertakings

	Total £m
Cost	
At 1 January 2009	5,724
Additions ¹	1,407
At 31 December 2009	7,131
Impairment provisions	
At 1 January 2009 and 31 December 2009	61
Net carrying value	
At 31 December 2009	7,070
At 31 December 2008	5,663

¹ The additions to investments in subsidiary undertakings include investments in the subsidiary companies BAE Systems (Holdings) Limited (£0.8bn), BAE Systems Australia Holdings Limited (£0.3bn) and BAE Systems Surface Ships Limited (£0.3bn).

4. Debtors

	2009 £m	2008 £m
Due within one year		
Corporation tax recoverable	243	98
Amounts owed by subsidiary undertakings	7,188	9,197
Amounts owed by Group joint ventures	3	6
Other debtors	6	8
Prepayments and accrued income	26	30
	7,466	9,339
Due after one year		
Other debtors	14	3
	14	3

Other debtors includes cash collateral of £11m (2008 £nil)

5. Other financial assets and liabilities

	2009 Assets £m	2009 Liabilities £m	2008 Assets Restated ² £m	2008 Liabilities Restated ² £m
Due within one year				
Cash flow hedges – foreign exchange contracts	4	–	9	–
Other foreign exchange/interest rate contracts	258	(255)	694	(598)
	262	(255)	703	(598)
Due after one year				
Cash flow hedges – foreign exchange contracts	5	–	17	–
Other foreign exchange/interest rate contracts	174	(327)	312	(574)
Debt-related derivative financial instruments – assets ¹	–	–	149	–
	179	(327)	478	(574)

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)

2 The balance sheet for the year ended 31 December 2008 has been restated to reflect a grossing up of derivatives and foreign exchange/interest rate contracts

Full disclosures relating to the Group's other financial assets and liabilities and financial risk management strategies are given in the Financial review section of the Directors' report and note 30 to the Group accounts

NOTES TO THE COMPANY ACCOUNTS *CONTINUED***6. Loans and overdrafts**

	2009 £m	2008 £m
Due within one year		
Bank loans and overdrafts	15	20
European Investment Bank loans, final instalment 2009	–	4
SYSTEMS 2001 Asset Trust Option Aircraft bond	22	25
	37	49
Due after one year		
Euro-Sterling £100m 10¼% bond, repayable 2014	100	100
SYSTEMS 2001 Asset Trust Option Aircraft bond, final instalment 2013	119	158
Debt-related derivative financial instruments – liabilities	14	–
	233	258

Bank loans and overdrafts are at a floating rate of interest

The European Investment Bank borrowing, fixed with an interest rate of 6.86%, was repaid during the year

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 2009 of 2.84% (2008 6.97%)

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 2009					
Carrying amount	37	29	204	–	270
At 31 December 2008					
Carrying amount ¹	49	25	133	100	307
Debt-related derivative financial instruments – assets	–	–	(32)	(117)	(149)
Carrying amount including debt-related derivative financial instruments – assets	49	25	101	(17)	158

¹ The carrying amount of loans and overdrafts at 31 December 2008 excluded debt-related derivative financial assets of £149m presented as other financial assets

The total amount of loans repayable by instalments, where any instalment is due after five years, is £nil (2008 £188m)

7. Creditors

	2009 £m	2008 £m
Due within one year		
Amounts owed to subsidiary undertakings	12,615	11,196
Amounts owed to Group joint ventures	1,325	1,468
Other creditors ¹	511	173
Accruals and deferred income	39	36
	14,490	12,873
Due after one year		
Other creditors	3	6
	3	6

¹ Other creditors includes the regulatory penalties of £278m in 2009 reflecting the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3

8 Provisions for liabilities and charges

	Contracts and other £m
At 1 January 2009	120
Created	8
Reclassified to other creditors	(48)
Utilised	(9)
Released	(16)
Discounting	6
At 31 December 2009	61

9. Contingent liabilities and commitments

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £2,646m (2008 £2,621m) which are included in the Group's borrowings have been guaranteed by the Company

10. Share capital

	Equity Ordinary shares of 2.5p each		Non-equity Special Share of £1		Total
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2008	3,574	90	1	1	90
Exercise of options	8	—	—	—	—
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	—	—	—	—
At 31 December 2009	3,585	90	1	1	90

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares

As at 31 December 2009, 43,952,360 (2008 55,038,953) ordinary shares of 2.5p each with an aggregate nominal value of £1,098,809 (2008 £1,375,974) were held in treasury. During 2009, 11,086,593 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme.

Authorised share capital

As agreed by the shareholders at the 2009 Annual General Meeting, the Company's Articles of Association were amended with effect from 1 October 2009 to remove the requirement for the Company to have an authorised share capital, the concept of which was abolished under the Companies Act 2006.

NOTES TO THE COMPANY ACCOUNTS *CONTINUED***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 90 to 111 of this report.

	Executive Share Option Scheme				Save-As-You Earn			
	2009	Weighted average exercise price £	2008	Weighted average exercise price £	2009	Weighted average exercise price £	2008	Weighted average exercise price £
	Number of shares '000		Number of shares '000		Number of shares '000		Number of shares '000	
Outstanding at the beginning of the year	11,262	3.48	15,046	3.35	142	1.56	296	1.25
Exercised during the year	(663)	2.37	(3,164)	2.69	(142)	1.56	(145)	0.95
Expired during the year	(1,854)	4.19	(620)	4.37	–	–	(9)	1.26
Outstanding at the end of the year	8,745	3.41	11,262	3.48	–	–	142	1.56
Weighted average remaining life (years)		6		6		–		1
Range of exercise price of outstanding options (£)	1.72 – 4.79		1.72 – 4.79			–		1.56
Expense recognised for the year (£m)		1		3		–		–

	Share Matching Plan		Performance Share Plan		Restricted Share Plan	
	2009	2008	2009	2008	2009	2008
	Number of shares '000	Number of shares '000	Number of shares '000	Number of shares '000	Number of shares '000	Number of shares '000
Outstanding at the beginning of the year	987	280	8,508	9,874	80	351
Granted during the year	2,490	819	4,765	2,665	–	–
Exercised during the year	(94)	(110)	(2,083)	(3,316)	(80)	(270)
Expired during the year	(75)	(2)	(503)	(715)	–	(1)
Outstanding at the end of the year	3,308	987	10,687	8,508	–	80
Weighted average remaining life (years)	2	2	5	4	–	–
Weighted average fair value of options granted (£)	3.43	4.79	2.81	3.85	–	–
Expense recognised for the year (£m)	2	1	4	5	–	–

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2008 £nil).

Information on options granted in the year can be found on page 160 (note 25 to the Group accounts).

12. Reserves

	Share premium account £m	Other reserves £m	Profit and loss account £m
At 31 December 2008	1,238	164	2,007
Loss for the year	-	-	(777)
Dividends paid	-	-	(534)
Share-based payments	-	-	52
Exercise of options	5	-	-
Purchase of own shares	-	-	(25)
Movements in hedging reserve	-	(45)	16
At 31 December 2009	1,243	119	739

Other reserves

Other reserves for the Company comprise capital reserve £24m (2008 £24m), hedging reserve £9m (2008 £54m), and non-distributable reserve arising from property disposals to other Group undertakings £86m (2008 £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.

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.

Treasury shares

As at 31 December 2009, 43,952,360 (2008 55,038,953) ordinary shares of 2 5p each with an aggregate nominal value of £1,098,809 (2008 £1,375,974) were held in treasury.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2009.

At 31 December 2009, the ESOP held 3,644,598 (2008 2,093,818) ordinary shares of 2 5p each with a market value of £13m (2008 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2009 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and December 2009 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Company profit

The Company's loss for the financial year was £777m (2008 profit £537m).

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 2009 was 721 (2008 655). Total staff costs, excluding charges for share options, were £93m (2008 £95m).

Total directors' emoluments, excluding company pension contributions, were £6,683,000 (2008 £9,509,000). 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 £1,486,000 (2008 £1,333,000).

FIVE-YEAR SUMMARY

Income statement^{1,2,3}	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Sales including Group's share of equity accounted investments					
Electronics, Intelligence & Support	5,637	4,459	3,916	4,007	3,697
Land & Armaments	6,738	6,407	3,538	2,115	1,270
Programmes & Support	6,298	4,638	5,327	4,615	4,660
International	4,253	3,333	3,359	3,428	3,138
HQ & Other Businesses	254	235	243	295	471
Intra-operating group sales	(765)	(529)	(673)	(695)	(655)
	22,415	18,543	15,710	13,765	12,581
Underlying EBITA⁵					
Electronics, Intelligence & Support	575	506	437	429	324
Land & Armaments	604	566	324	168	86
Programmes & Support	670	491	456	331	261
International	442	435	435	412	403
HQ & Other Businesses	(71)	(101)	(203)	(146)	(117)
	2,220	1,897	1,449	1,194	957
Profit/(loss) on disposal of businesses	68	238	40	13	(4)
Pension accounting gain	261	–	–	–	–
Regulatory penalties	(278)	–	–	–	–
Uplift on acquired inventories	–	–	(12)	–	(44)
EBITA⁴	2,271	2,135	1,477	1,207	909
Amortisation and impairment of intangible assets	(1,259)	(424)	(297)	(139)	(122)
Finance costs including share of equity accounted investments	(707)	697	93	(174)	(196)
Profit before taxation	305	2,408	1,273	894	591
Taxation expense including share of equity accounted investments	(350)	(640)	(373)	(248)	(147)
(Loss)/profit for the year from continuing operations	(45)	1,768	900	646	444
Profit for the year from discontinued operations	–	–	22	993	111
(Loss)/profit for the year	(45)	1,768	922	1,639	555
Balance sheet					
Intangible assets	11,253	12,306	9,559	7,595	8,217
Property, plant and equipment, and investment property	2,663	2,558	1,887	1,869	1,922
Non-current investments	852	1,040	787	678	1,730
Inventories	887	926	701	395	485
Assets held in Trust	227	–	–	–	–
Payables (excluding cash on customers' account) less receivables	(6,755)	(5,866)	(5,373)	(4,298)	(4,596)
Other financial assets and liabilities	(45)	240	52	6	(7)
Retirement benefit obligations	(4,679)	(3,365)	(1,629)	(2,499)	(4,101)
Provisions	(929)	(845)	(809)	(695)	(718)
Net tax	850	256	63	648	1,012
Net cash/(debt)	403	39	700	435	(1,277)
Disposal groups held for sale	–	–	64	–	137
Minority interests	(72)	(55)	(36)	(17)	(16)
Total equity attributable to equity holders of the parent	4,655	7,234	5,966	4,117	2,788

Movement in net cash/(debt) as defined by the Group	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Cash flow from operating activities	2,232	2,009	2,162	778	2,099
Net capital expenditure ⁶	(489)	(503)	(262)	(141)	(250)
Dividends from equity accounted investments	77	89	78	145	88
Assets contributed to Trust	(225)	-	-	-	-
Operating business cash flow	1,595	1,595	1,978	782	1,937
Acquisitions and disposals	(254)	(1,038)	(2,112)	1,330	(1,836)
Finance costs	(186)	(98)	(65)	(207)	(152)
Tax and dividends	(889)	(750)	(509)	(431)	(342)
Other movements ⁷	(132)	5	57	(11)	(52)
(Purchase)/issue of equity shares	(20)	(27)	603	(71)	373
Preference share conversion	-	-	245	6	-
Exchange movements	262	(374)	36	323	(219)
Net increase/(decrease) in net funds	376	(687)	233	1,721	(291)
Movement in cash on customers' account	(12)	26	32	(9)	(35)
Movement in net cash/(debt)	364	(661)	265	1,712	(326)
Opening net cash/(debt)	39	700	435	(1,277)	(668)
Impact of IFRS adoption	-	-	-	-	(283)
Closing net cash/(debt)	403	39	700	435	(1,277)
Other information	2009	2008	2007	2006	2005
Basic (loss)/earnings per share – total (pence)	(1 9)	49 6	26 6	50 7	17 4
Basic earnings per share – underlying ⁸ (pence)	40 7	37 1	30 1	23 5	18 5
Dividend per ordinary share (pence)	16 0	14 5	12 8	11 3	10 3
Number of employees, excluding share of employees of equity accounted investments, at year end	98,000	94,000	88,000	79,000	80,000
Capital expenditure including leased assets (£m)	522	552	341	538	347
Order book including the Group's share of equity accounted investments (£bn)	46 9	46 5	38 6	31 7	30 8

1 For the years ended 31 December 2005 and 2006 Airbus SAS is presented as a discontinued operation under IFRS

2 For the year ended 31 December 2005 the Avionics business is presented as a discontinued operation under IFRS

3 For the years ended 31 December 2005 and 2006 the operating group information presented under IFRS has been restated to reflect changes made to the Group's organisational structure

4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

5 EBITA excluding non-recurring items. From 2005 to 2008 non-recurring items are profit/(loss) on disposal of businesses and uplift on acquired inventories. In 2009 non-recurring items are profit on disposal of businesses, pension curtailment gains and regulatory penalties

6 Includes expenditure on property, plant and equipment, investment property, intangible assets and other investments

7 Other movements include cash flows from matured derivative financial instruments, cash flows from movement in cash collateral and other non-cash movements. See page 162

8 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives and non-recurring items. From 2005 to 2008 non-recurring items are profit/(loss) on disposal of businesses and uplift on acquired inventories. In 2009 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

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 advantages to using this service are:

- the payment is more secure than having a cheque sent by post,
- it avoids the hassle of paying in a cheque, and
- there is no risk of lost, stolen or out of date cheques.

A mandate form can be obtained from our website, by contacting Equiniti, or you will find one attached to the tax voucher of your last dividend payment. Overseas shareholders can arrange for their dividends to be paid in their local currency and more information can be obtained from www.shareview.com/overseas.

Shareview service

The Shareview service from our registrar, Equiniti, gives shareholders:

- direct access to data held on their behalf on the share register including recent share movements and dividend details, and
- the ability to change their address or dividend payment instructions online.

To sign up for Shareview you need the 'shareholder reference' printed on your proxy form or dividend stationery. There is no charge to register.

When you register with the site, you can register your preferred format (post or e-mail) for shareholder communications. If you select 'e-mail' as your mailing preference, you will be sent shareholder communications, such as proxy forms and annual results, by e-mail instead of post, as long as this option is available.

If you have your dividends paid straight to your bank account, and you have selected 'e-mail' as your mailing preference, you can also collect your tax voucher electronically. Instead of receiving the paper tax voucher, you will be notified by e-mail with details of how to download your electronic version.

However, if you choose 'post' as your preference, you will be sent paper documents as usual.

Visit the website at 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. If you would like 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 from 8.30am to 5.30pm Monday to Friday.

Telephone number from outside the UK +44 121 415 7058

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 2009 was 359.5p and the range during the year was 306p to 408.25p.

American Depositary Receipts

The 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

Website www.adr.com

Electronic shareholder communications

Following approval of a resolution by shareholders at our 2007 Annual General Meeting, the Company has been authorised to use electronic communications when sending information to our shareholders, as permitted by the Companies Act 2006. Using electronic communications helps us reduce the environmental impact of our business by limiting the amount of paper we use and assists us in managing our costs. We periodically consult with shareholders to check how they wish to receive information from us and 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.

Shareholders may receive electronic communications in one of two ways

- via e-mail – This option is available through Shareview. Shareholders will receive an e-mail notification when a new document is made available, or
- via our website – Shareholders will receive a notification by post when a new document is made available

Notwithstanding any election, the Company may, at its sole and absolute discretion, send any notification or information to shareholders in hard copy form

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.

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 Financial Services Authority (FSA) before getting involved by visiting www.fsa.gov.uk/register/,
- report the matter to the FSA either by calling 0845 606 1234 or visiting www.money.made.clear.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 FSA website www.money.made.clear.fsa.gov.uk

Financial calendar

Financial year end	31 December
Annual General Meeting	5 May 2010
2009 final ordinary dividend payable	1 June 2010
2010 half-yearly results announcement	29 July 2010
2010 interim ordinary dividend payable	30 November 2010
2010 full year results – preliminary announcement	February 2011
– report and accounts	April 2011
2010 final ordinary dividend payable	June 2011

Analysis of share register at 31 December 2009

	Ordinary shares of 2.5p			
	Accounts		Shares	
	Number 000	%	Number million	%
By category of shareholder				
Individuals	104.7	91.8	102.3	2.9
Nominee companies	8.3	7.3	3,389.1	94.5
Banks	–	–	2.2	0.1
Other	1.0	0.9	91.0	2.5
	114.0	100.0	3,584.6	100.0
By size of holding				
1 – 99	23.3	20.4	1.1	–
100 – 499	32.2	28.2	8.7	0.2
500 – 999	23.2	20.4	16.5	0.4
1,000 – 9,999	32.9	28.9	77.8	2.2
10,000 – 99,999	1.5	1.3	38.3	1.1
100,000 – 999,999	0.6	0.5	235.0	6.6
1,000,000 and over	0.3	0.3	3,207.2	89.5
	114.0	100.0	3,584.6	100.0

GLOSSARY

ADF	Australian Defence Force
AGM	Annual General Meeting
ATTAC	Availability Transformation Tornado Aircraft Contract
ATV	All-Terrain Vehicle
AWD	Air Warfare Destroyer
BvS10 Viking	Amphibious armoured All-Terrain Vehicle
C4ISR	Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance
CV90	Combat Vehicle 90
CVR(T)	Combat Vehicle Reconnaissance (Tracked) family of armoured fighting vehicles
DASS	Defensive Aids Sub-System
DoD	Department of Defense
DVE-FOS	Driver's Vision Enhancer Family of Systems
EBITA	Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
EC	Executive Committee
EPS	Earnings per Share
EU	European Union
FAP	Final Average Pay
FMV	Swedish Defense Materiel Administration
FMTV	Family of Medium Tactical Vehicles
FPP	Final Pensionable Pay
FRIP	Financial Risk Insurance Programme
FRES	Future Rapid Effects System
FRS	Financial Reporting Standard
GAAP	Generally Accepted Accounting Principles
GAO	The US's Government Accountability Office
GDP	Gross Domestic Product
HBCT	Heavy Brigade Combat Team
HERTI	Highly autonomous medium-altitude long-endurance unmanned air system
Home market	A home market is one in which the Group has established, or seeks to establish, a strong domestic presence as a key part of the defence industry capability in that country. BAE Systems has seven home markets: Australia, India, Saudi Arabia, South Africa, Sweden, the UK and the US.
IAS	International Accounting Standard
IBP	Integrated Business Plan
IDIQ	Indefinite Delivery/Indefinite Quantity
IFRIC	International Financial Reporting Interpretations Committee
IT	Information Technology

JAVELIN	Joint Approach to VC-10 Engineering and Logistics Integration with the UK's Royal Air Force
JLTV	Joint Light Tactical Vehicle
JTAS	Joint and Allied Threat Awareness System
KPI	Key Performance Indicator
LCM	Lifecycle Management
LHD	Landing Helicopter Dock
Line leader	An individual with specific profit and loss accountability for a business
LRIP	Low-Rate Initial Production
LTA	Lifetime allowance
LTIP	Long-Term Incentive Plan
LTPA	Long-Term Partnering Agreement
M777	A lightweight 155mm field howitzer
MASS	Munitions Acquisition – Supply Solution
MEADS	Medium Extended Air Defence System
MoD	Ministry of Defence
MRAP	Mine Resistant Ambush Protected wheeled vehicle
NLOS-C	Non-Line-of-Sight Cannon
OAS	Operational Assurance Statement a six-monthly review of internal controls and risk management processes
OPV	Offshore Patrol Vessel
QBR	Quarterly Business Review
RAF	The UK's Royal Air Force
RCF	Revolving Credit Facility
R&S	Readiness & Sustainment – the provision of through-life operational capability for the armed forces
RSAF	The Royal Saudi Air Force
RG31	Mine protected armoured personnel carrier
SMM	Safety Maturity Matrix
STOVL	Short Take-Off and Vertical Landing
SV	Specialist Vehicle
TACP	Tactical Air Control Party
TAS	Typhoon Availability Service
TPL	Total Performance Leadership
TSP	Tornado Sustainment Programme
TSR	Total Shareholder Return
TRMC	Treasury Review Management Committee
UAS	Unmanned Aircraft Systems

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Corporate Responsibility Report 2009

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- www.baesystems.com/cr09/**

Notice of Annual General Meeting

- Accessible in pdf format
- Vote online
- Links to further information

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

Cover image

Typhoon

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