




# ANNUAL REPORT 2013





At BAE Systems, we serve the needs of our customers by delivering a wide range of advanced defence, aerospace and security solutions that provide a performance edge. With some 84,600 employees<sup>1</sup> in six continents, we work together with local partners to develop, engineer, manufacture and support the innovations that increase defence sovereignty, sustain economies and safeguard commercial interests.

**That's Inspired Work.**

<sup>1</sup> Including share of equity accounted investments.

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. BAE Systems plc and its directors accept no liability to third parties in respect of this report save as would arise under English law. Accordingly, any liability to a person who has demonstrated reliance on any untrue or misleading statement or omission shall be determined in accordance with schedule 10A of the Financial Services and Markets Act 2000. It should be noted that schedule 10A and section 463 Companies Act 2006 contain limits on the liability of the directors of BAE Systems plc so that their liability is solely to BAE Systems plc.

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For further information visit:  
[www.baesystems.com](http://www.baesystems.com)



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## Results in brief

# “OVERALL, THE GROUP DELIVERED A SOLID PERFORMANCE IN 2013.”

Ian King, Chief Executive

<b>Sales<sup>3</sup></b> <span>KPI</span> <b>£18,180M</b> 2013 <b>£17,905M<sup>1</sup></b> 2012	<b>Underlying EBITA<sup>4</sup></b> <span>KPI</span> <b>£1,925M</b> 2013 <b>£1,862M<sup>1,2</sup></b> 2012	<b>Underlying earnings<sup>5</sup> per share</b> <span>KPI</span> <b>42.0P</b> 2013 <b>38.7P<sup>1,2</sup></b> 2012
<b>Order backlog<sup>3,6</sup></b> <b>£42.7BN</b> 2013 <b>£42.5BN<sup>1</sup></b> 2012	<b>Operating profit</b> <b>£806M</b> 2013 <b>£1,605M<sup>1,2</sup></b> 2012	<b>Basic earnings per share<sup>7</sup></b> <b>5.2P</b> 2013 <b>29.3P<sup>1,2</sup></b> 2012
<b>Operating business cash flow<sup>8</sup></b> <span>KPI</span> <b>£147M</b> 2013 <b>£2,692M</b> 2012	<b>Net (debt)/cash (as defined by the Group)<sup>9</sup></b> <b>£(699)M</b> 2013 <b>£387M</b> 2012	<b>Dividend per share</b> <b>20.1P</b> 2013 <b>19.5P</b> 2012

- Sales<sup>3</sup> increased by 2% to £18.2bn
- Underlying EBITA<sup>4</sup> increased by 3% to £1.9bn and underlying earnings<sup>5</sup> per share increased by 9% to 42.0p
- Equitable conclusion reached on price escalation negotiations with the Kingdom of Saudi Arabia
- Order backlog<sup>3,6</sup> of £42.7bn maintained at 2012 levels with non-UK/US order intake<sup>3</sup> of £9.3bn
- Robust, investment grade balance sheet, with net debt<sup>9</sup> of £699m at year end
- Non-cash goodwill impairment of £865m in US businesses, due to increased weighted average cost of capital and taking into account lower US defence spending
- Full year dividend increased by 3% to 20.1p per share
- £850m returned to shareholders in 2013, including £212m on the share repurchase programme

**KPI** References to Key Performance Indicators (KPIs) throughout the Annual Report

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7 to the Group accounts).

2 Restated on adoption of the revised International Accounting Standard 19, Employee Benefits.

3 Including share of equity accounted investments.

4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

5 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).

6 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.

7 Basic earnings per share in accordance with International Accounting Standard 33, Earnings per Share.

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

9 See note 10 to the Group accounts.



## Outlook for 2014

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Following last year's non-recurring benefit from the Salam price escalation settlement, together with continuing US budget pressures, the Group's reported earnings<sup>5</sup> per share is expected to reduce by approximately 5% to 10% compared to 2013.

### Reporting segments

Electronic Systems: Sales<sup>3</sup>, in US dollars, in 2014 are expected to be similar to those in 2013 with margins at the high end of a 12% to 14% range.

Cyber & Intelligence: Sales<sup>3</sup> in 2014 are expected to be broadly in line with those in 2013 with margins in an improved 8% to 10% range.

Platforms & Services (US): In 2014, sales<sup>3</sup> in the Land & Armaments business (adjusted for the transfer out of the UK Munitions business into Platforms & Services (UK)) are expected to be some 20% to 25% lower with margins of around 9%. Sales<sup>3</sup> in the Support Solutions business are expected to be a little lower in 2014 with mid-single digit margins.

Platforms & Services (UK): Following the trading in 2013 of the price escalation on the Salam Typhoon contract, and excluding the transfer of the UK munitions business, sales<sup>3</sup> are expected to reduce by around 5% with margins expected to return to a 10% to 12% range.

Platforms & Services (International): Sales<sup>3</sup> are expected to be similar to 2013 with margins expected to be in a 10% to 12% range.

# CHAIRMAN'S LETTER

Sir Roger Carr, Chairman



## “THE BOARD HAS ESTABLISHED A CULTURE OF GOOD GOVERNANCE AND HIGH BUSINESS ETHICS.”

I write as the newly appointed Chairman who can take no credit for the Company's solid performance in 2013, but with a deep commitment to building on the firm foundation left by my predecessor, Sir Richard Olver.

In addition to improved performance, there is no doubt that under Sir Richard's Chairmanship, the Board established a culture of good governance and high business ethics. These have been adopted across the business and are respected throughout the industry. The management teams I inherit are experienced, able and focused on operational excellence and the delivery of shareholder value.

In 2013, the Group delivered good growth in sales and underlying profit. Strong cash flows in prior years facilitated the implementation of a three-year share repurchase programme of up to £1bn, the continued support of our pension obligations and the recommendation of a final dividend of 12.1p per share, making a total 20.1p per share for the year.

The business model is balanced and robust, with deep roots in the US, the Middle East and the UK, and strong links to our customers in the Asia Pacific region.

The defence budget in the US, the Group's largest market, has been through a period of uncertainty, but there are signs that some

clarity is starting to emerge with the recent agreement on a two-year budget.

Over the next 12 months, the Company will seek to sustain its order backlog in defence and strengthen the position of its cyber security business.

In a challenging climate for defence spending, the executive will continue to focus on disciplined cost management in those markets that are contracting and increased sales endeavours in those parts of the world where new business opportunities are both appropriate and available.

In the latter part of the year, management was successful in reaching agreement in principle with the UK's Ministry of Defence on measures to enable the implementation of a restructuring of the UK naval ships business, including changes to the Queen Elizabeth Class aircraft carrier contract. In addition, agreement was reached with the Kingdom of Saudi Arabia on outstanding commercial issues associated with the Typhoon order. These agreements resolved two uncertainties of the recent past and provide a more stable platform on which to work with these important customers to address their future defence and security priorities.

In considering the future potential of the business, my initial findings are based on five fundamentals:

- BAE Systems is one of the most important companies in the UK and one of the world's greatest defence contractors. It has the mix of products and services and breadth of markets to grow and prosper as an independent organisation;
- its businesses are led by seasoned, talented professionals and populated by skilled and enthusiastic employees who take great pride in their work;
- its products are respected across the globe for their quality, cutting-edge technology, reliability in action and performance;
- its culture and ethos have been established to achieve the highest standards: honesty and openness in all business dealings, respect for those that work for the Company, appreciation for those that trade with the Company and recognition and reward for those that own the Company; and
- its Board comprises a diverse mix of experienced individuals, chosen for their relevant skillset, valued for their independent mind-set and collectively supporting management when appropriate and challenging when necessary.

Dividend (pence)

**20.1P +3%**

2013	20.1
2012	19.5
2011	18.8
2010	17.5
2009	16.0

During my first year as Chairman, it is my intention to capitalise on these fundamentals by working closely with management, visiting our locations, meeting our customers and engaging with our shareholders.

Together with colleagues, we will pressure test our strategy, hone our competitive edge, develop our management team, strengthen all our relationships and reinforce the principles of ethical business through the organisation.

I am clear that in a rapidly changing world, the road ahead will not be smooth, but I take up the new role with a sense of privilege in my appointment, respect for the organisation, enthusiasm for the task and confidence in the future.

#### Directors

Sir Peter Mason, a non-executive director, retired from the Board of BAE Systems plc on 8 May. Ian Tyler joined the Board as a non-executive director of the Company on that date.

In June, Chris Grigg was appointed a non-executive director of the Company with effect from 1 July.

Lee McIntire, a non-executive director, resigned from the Board of BAE Systems plc on 20 August.

I joined the Board as a non-executive director of BAE Systems plc and Chairman designate on 1 October and succeeded Sir Richard Oliver as Chairman on 1 February 2014. Sir Richard stepped down from the Board on that date.

On 1 February 2014, Linda Hudson retired as President and Chief Executive Officer of BAE Systems, Inc. and as an executive director of BAE Systems plc. On the same date, Jerry DeMuro was appointed as President and Chief Executive Officer of BAE Systems, Inc. and as an executive director of BAE Systems plc. He will also serve on BAE Systems' Executive Committee.

#### Dividend

The Board has recommended a final dividend of 12.1p per share making a total of 20.1p per share for the year, an increase of 3% over 2012. At this level, the annual dividend is covered 2.1 times by underlying earnings (2012 2.0 times). Subject to shareholder approval at the 2014 Annual General Meeting, the dividend will be paid on 2 June 2014 to holders of ordinary shares registered on 22 April 2014.

#### Reporting

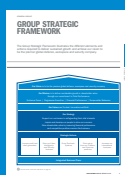
This Annual Report has been produced in compliance with new narrative reporting regulations. The principal change being the requirement to produce a Strategic Report that provides readers with a clear and focused explanation of a company's strategy, business model, key risks and performance. To date, BAE Systems has set high standards for the quality of its narrative reporting and I hope that you will find that this report fulfils the requirements and intentions of the new regulations, and continues to bring clarity and transparency to the Group's activities.



Sir Roger Carr, Chairman

# STRATEGIC REPORT

## WHAT YOU WILL FIND IN THIS SECTION



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The Group Strategic Framework integrates the Group's major goals and actions, and defines the direction and shape of the Group over the long term.



### 09 BUSINESS MODEL

How BAE Systems serves the needs of its customers by delivering a wide range of advanced defence, aerospace and security solutions.



### 20 CHIEF EXECUTIVE'S REVIEW

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A summary of the principal risks identified by the Group based on the likelihood of occurrence and potential impact.



### 32 GROUP FINANCIAL PERFORMANCE

Peter Lynas, Group Finance Director, summarises the financial performance of the Group in 2013.



### 36 SEGMENTAL PERFORMANCE

The 2013 performance and characteristics of the Group's five principal reporting segments are summarised.



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Creating a sustainable business requires more than financial results. The Group places great importance not just on what it does, but how it does it.



### 64 GOVERNANCE SUMMARY

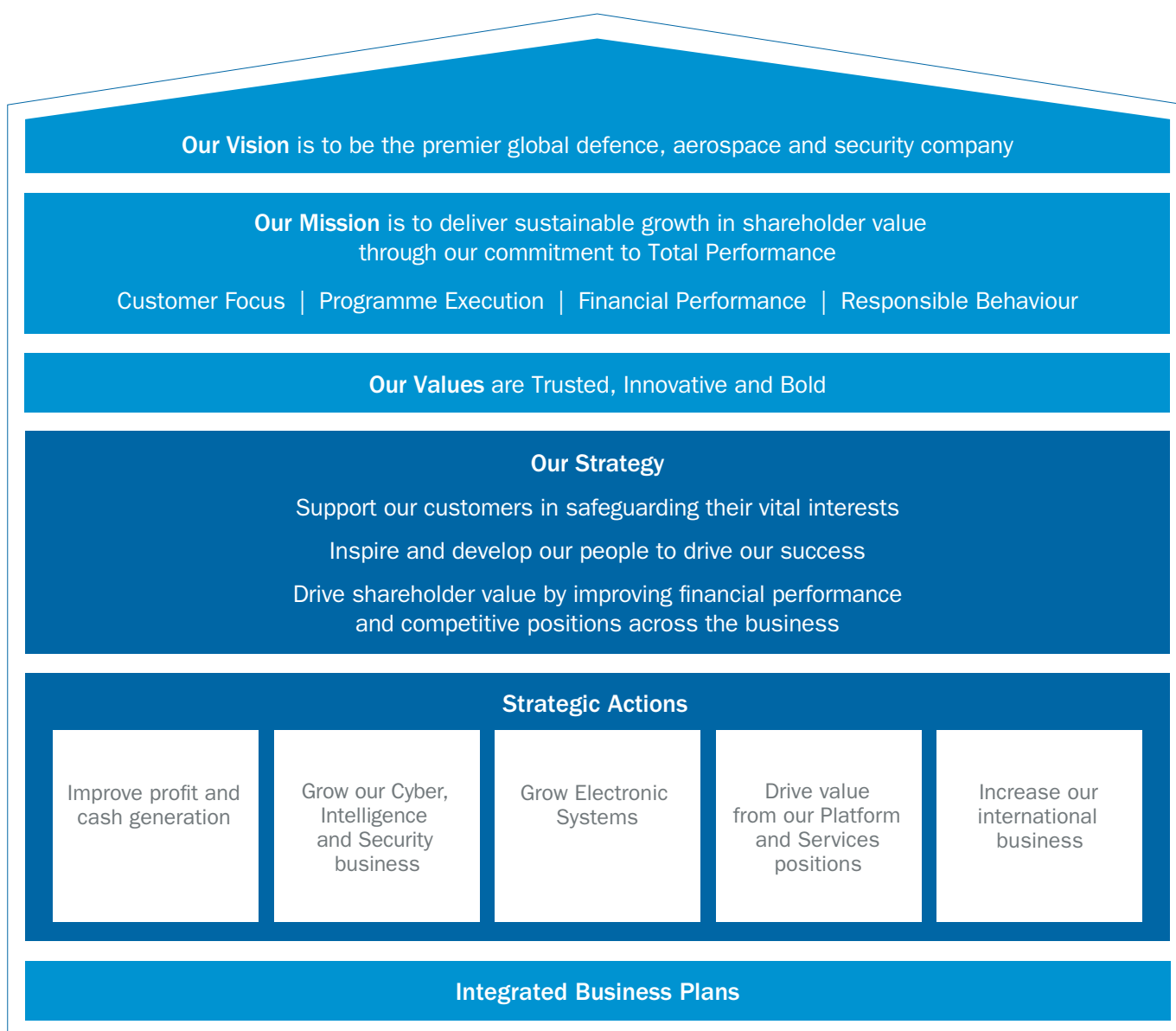
An overview of the Group's approach to governance and directors' remuneration.

*This Strategic Report was approved by the board of directors on 19 February 2014.*

*David Parkes, Company Secretary*

# GROUP STRATEGIC FRAMEWORK

The Group Strategic Framework illustrates the different elements and actions required to deliver sustained growth and achieve our vision to be the premier global defence, aerospace and security company.



The key elements of the Group Strategic Framework are explained below. Consistent with the strong momentum BAE Systems has built over recent years, the Group Strategic Framework remains unchanged for 2014.

#### Our Vision

Our Vision provides a clear definition of the future we are striving to achieve, which drives us to go above and beyond and outperform the competition.

#### Our Mission

Our Mission describes our overall goal and the philosophy behind our activities, which is key to achieving our Vision. Total Performance is demonstrated in every aspect of the way we do business.

#### Our Values

Our Values enable us to achieve a culture of Total Performance. Living these shared values by delivering on our commitments, creating leading-edge solutions and taking the initiative, underpins how we deliver our strategy.

#### Our Strategy

Our Strategy defines the direction and shape of the Group over the long term. This enables us to prioritise resources and remain agile to adapt to changes in this challenging environment.

#### Strategic Actions

Our Strategic Actions are the five key focus areas that will enable the business to meet our objectives and deliver against the overall strategy.

#### Integrated Business Plans

Our Integrated Business Plans translate our overarching strategy into operational plans that are delivered through the lines of business.

Delivery of the strategy is supported by the Group's business model which is detailed on pages 9 to 19 and brought to life with examples of the strategy in action.



# BUSINESS MODEL

BAE Systems is a global defence, aerospace and security company, delivering a wide range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology and support services. The Group’s business model focuses not just on what it does, but how it does it.

## DELIVERING SUSTAINABLE GROWTH IN SHAREHOLDER VALUE THROUGH TOTAL PERFORMANCE

CUSTOMER  
FOCUS

➞ Page 10

PROGRAMME  
EXECUTION

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References to the business model throughout the Annual Report

# CUSTOMER FOCUS

➤ See Segmental performance section on pages 36 to 61



## WHAT IS IT?

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

## WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Broad customer base and long-standing relationships with the governments of the US, UK, Saudi Arabia and Australia.
- Responsiveness to urgent operational requirements.
- Focused investment in research and development and substantial intellectual property.

## HOW DOES THIS HELP TO CREATE VALUE?

Delivering on commitments and performance also increases the likelihood of further opportunities on future programmes.

## HOW IS IT MEASURED?

➤ See the Customer Focus Key Performance Indicator on page 28



BAE Systems is a leading provider of commercial aircraft Full Authority Digital Engine Controls (FADEC) through its FADEC International joint venture with Sagem, and continues to provide cutting-edge technology for commercial jet engine applications, including for the CFM 56 family of engines. Building on many years' experience and reflecting the strong customer focus embedded in the business, BAE Systems, as a tenured partner in the FADEC Alliance, has been selected to provide the FADEC for the next-generation CFM Leap engine powering the Airbus A320neo and Boeing 737 MAX.

*Image: One of our employees at Fort Wayne, Indiana, US*



# PROGRAMME EXECUTION

➔ See Segmental performance section on pages 36 to 61

## WHAT IS IT?

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

## WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Talented, diverse and skilled workforce.
- Breadth of technological capability.
- World-class project management processes, including Lifecycle Management, regular contract reviews and early identification of programme risk.
- Robust and effective supplier management.

## HOW DOES THIS HELP TO CREATE VALUE?

Control of costs and schedule throughout the lifecycle of programmes maximises returns for the Group.

## HOW IS IT MEASURED?

➔ See the Programme Execution Key Performance Indicator on page 28

⬆ HMS Queen Elizabeth and HMS Prince of Wales are two aircraft carriers currently under construction by the Aircraft Carrier Alliance, a unique partnering relationship between BAE Systems, Thales, Babcock and the UK Ministry of Defence. Effective programme execution is key to the successful delivery of the programme. Each 65,000 tonne carrier will provide the armed forces with a four acre military operating base that can be deployed worldwide and will be versatile enough to be used for operations ranging from supporting war efforts to providing humanitarian aid.

*Image: The Queen Elizabeth Carrier at Rosyth Dockyard, Fife, UK*



# FINANCIAL PERFORMANCE

➞ See Group financial performance section on pages 32 to 35

## WHAT IS IT?

The Group sets challenging financial targets through its Integrated Business Planning process to maximise financial performance and drive long-term shareholder value.

## WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Robust procedures for risk management and internal control.
- Long-term strategy and five-year plan reviewed and updated annually.
- Regular reviews of performance relative to the Integrated Business Plan.
- Business portfolio subject to regular strategic review.
- A clear capital allocation policy, consistent with sustaining an investment grade credit rating.

## HOW DOES THIS HELP TO CREATE VALUE?

Achievement of financial targets underpins the Group's strategy and delivers returns to shareholders.

## HOW IS IT MEASURED?

➞ See the Financial Performance Key Performance Indicators on pages 26 and 27

- ⌚ Under the 2009 Typhoon Tranche 3A contract, a total of 88 aircraft have been ordered for the four European partner nations – Germany, Italy, Spain and the UK. Tranche 3 capability includes over 350 modified parts designed, engineered and assembled ready to incorporate the most advanced capability enhancements, including provision for conformal fuel tanks and extra electrical power and cooling to cater for an E-Scan radar, which will enhance performance, reliability and availability whilst delivering lower support costs.

*Image: Typhoon production at Warton Aerodrome, Lancashire, UK*

# RESPONSIBLE BEHAVIOUR

➔ See Sustainability summary section on pages 62 and 63

## WHAT IS IT?

Responsible Behaviour is fundamental to the business. The Group's Code of Conduct provides guidance on the principles and standards of business conduct expected of all employees. Together with the Group's Responsible Trading Principles, the Code of Conduct underpins the Group's business activities.

## WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- A culture of integrity.
- Robust Code of Conduct and Responsible Trading Principles.
- A global ethics helpline to provide employees with guidance and a means to raise concerns in confidence.
- Robust assurance processes, compliance systems, support and training.

## HOW DOES THIS HELP TO CREATE VALUE?

Responsible business practices underpin the Group's ability to operate and its business reputation, and support employees in making the right decisions to drive business performance.

## HOW IS IT MEASURED?

- ➔ See Responsible Behaviour Key Performance Indicator on page 28, and ethics, safety, diversity and inclusion, and environmental metrics on pages 112 to 117

- ⬆ BAE Systems places great importance on the way it conducts business and continues to reinforce a culture of responsible behaviour. The Group has established a network of Ethics Officers to support employees who may have concerns or queries. In 2013, over 40% of ethics issues raised were through discussions with Ethics Officers.

*Image: One of our employees at the North Ryde site, New South Wales, Australia*



# MULTIPLE MARKETS

➔ See Chief Executive's review section on pages 20 to 23

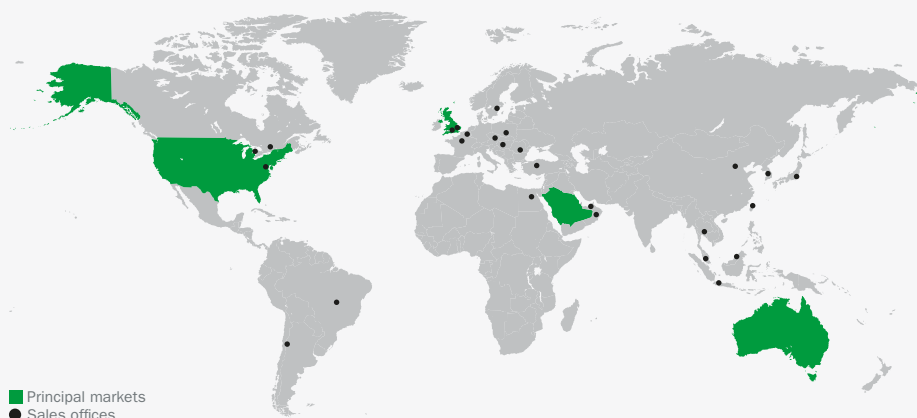
BAE Systems is a global business with positions across four principal markets and a track record of success in international markets.

## Market overview

BAE Systems has a broad geographic base with business operations in four principal markets around the world, in the US, the UK, the Kingdom of Saudi Arabia and Australia. These markets are identified as having a significant and sustained commitment to defence and security. They are countries that welcome foreign investment to develop and sustain a domestic defence industrial capability, building long-term and trusted customer relationships.

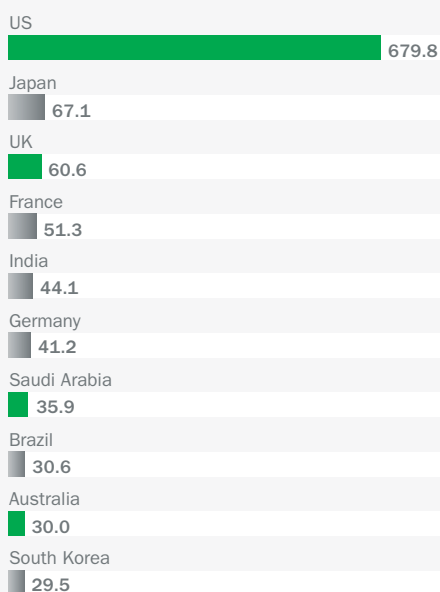
BAE Systems has a strong international market presence with well-established relationships across the globe, supported by regional sales offices.

The Group's strategy continues to focus on the importance of winning international business, where growth markets remain. Success in these international defence, aerospace and security markets is evident in the significant order intake in markets outside the US and UK.



## Accessible global defence markets

Top ten global defence markets accessible for business by the Group (\$bn)

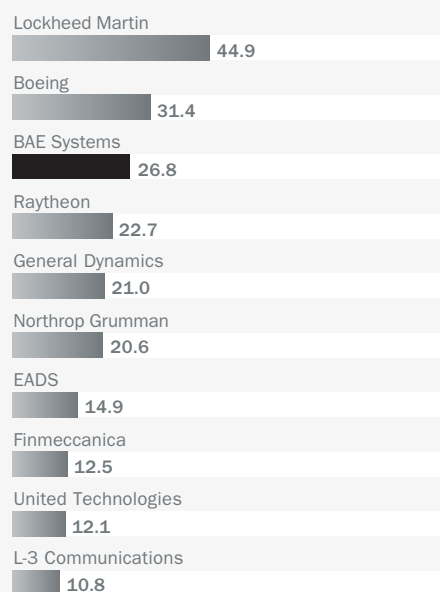


■ Principal markets

Source: Jane's Defence Budgets (based on 2012 total defence expenditure)

## BAE Systems' global defence market position

Top ten global defence contractors' revenue (\$bn)



Source: Defense News (based on 2012 revenues)



BAE Systems is an established part of the defence industrial capability in the US, the UK, the Kingdom of Saudi Arabia and Australia, where its principal operations are based. The Group's global footprint and strong track record in export sales provides ongoing opportunities across international markets.

#### WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Established customer base and relationships.
- In-depth knowledge and experience of working in international markets.

#### HOW DOES THIS HELP TO CREATE VALUE?

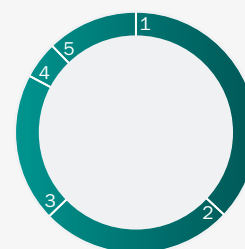
With near-term budget pressures in some markets, the Group's broad geographic base provides a resilient business portfolio.

Lasting relationships with customers not only mean the Group has clear sight of value generation in the long term, but also the ability to recognise evolving requirements for programme and capability developments.

#### HOW IS IT MEASURED?

Order intake and sales by market, with a focus on non-UK/US order intake →

Sales<sup>1</sup> by principal market (%)



1	US	37
2	UK	26
3	Saudi Arabia	20
4	Australia	5
5	Other international	12



#### US

BAE Systems is a top ten US defence contractor, offering a balanced portfolio of products and services in defence, aerospace and security domains, including the operational support of equipment used around the world by US forces and their allies.

**31,500**

employees<sup>1</sup>

**TOP 10**

US defence contractor



#### UK

BAE Systems plays a vital role in the UK's defence capabilities across air, maritime and land domains, including military and technical service contracts. BAE Systems also plays a key role in security and intelligence with customers in both government and commercial markets.

**33,300**

employees<sup>1</sup>

**NUMBER 1**

supplier to the UK Ministry of Defence



#### International

In international markets, including the Kingdom of Saudi Arabia and Australia, the Group is seeing good growth in order intake, leading to anticipated growth in international sales. In 2013, non-UK/US order intake<sup>1</sup> was £9.3bn, building on the £11.2bn booked in 2012.

In Saudi Arabia, BAE Systems supports the operational capability of the Royal Saudi air and naval forces, and is investing in the development of Saudi defence capabilities.

In Australia, BAE Systems supplies leading capability across air defence, land combat systems, naval systems and security.

India's growing defence and security market offers opportunities for BAE Systems, particularly in the land and air sectors. The Group continues to focus on growing order intake and developing in-country relationships.

**19,800**

employees<sup>1</sup>

**£9.3BN**

non-UK/US order intake<sup>1</sup> in 2013

**NUMBER 1**

in-country defence supplier in Saudi Arabia and Australia

<sup>1</sup> Including share of equity accounted investments.

# OUTSTANDING CAPABILITIES

➞ See Segmental performance section on pages 36 to 61

① Applied Intelligence (formerly BAE Systems Detica) has launched its defence-grade cyber security product, CyberReveal®, to the commercial market. CyberReveal® is an analytics and investigation product that gives companies the intelligence they need to protect their sensitive commercial information.



## ELECTRONIC SYSTEMS

➞ See pages 38 to 42

Electronic Systems has advanced technology, high-integrity electronics capabilities with a large portfolio of annually-funded contracts, and significant Group-funded research and development invested in the business.

**Electronic Combat** combines the Electronic Protection, Electronic Warfare and Electronic Attack product lines, and provides a depth of capability in integrated electromagnetic systems for airborne applications.

**Survivability & Targeting** includes situational awareness, targeting and survivability systems, such as electro-optic sensor products, guidance systems, handheld targeting and infrared countermeasures systems for soldiers and vehicles.

**Communications & Control** has a strong footing in radio frequency communication and datalinks, and provides military aircraft controls and displays, together with platform integration capabilities.

**Intelligence, Surveillance & Reconnaissance (ISR)** addresses the market for airborne persistent surveillance, identification systems, signals intelligence and space products.

**Commercial Aircraft electronics** addresses the commercial aircraft electronics market, including fly-by-wire flight controls, full authority digital engine controls, cockpit controls, head-up displays, cabin management systems and power management systems.

**HybriDrive® propulsion** delivers power and energy management solutions, including vehicle hybrid drive systems.



## CYBER & INTELLIGENCE

➞ See pages 43 to 47

Cyber & Intelligence comprises government-focused intelligence-based services, and government and commercial cyber security activities.

**Intelligence & Security** delivers a broad range of services, including systems development, IT, cyber operations and intelligence analysis to enable the US military and government to recognise, manage and defeat threats.

**Global Analysis and Operations** provides mission-enabled analytic solutions and support to operations across the homeland security, law enforcement, defence, intelligence and counter-intelligence communities.

**GEOINT-ISR** develops and supports software systems and mission applications for geospatial tasking for the US defence and intelligence communities.

**IT Solutions** develops, deploys and maintains mission applications focused on information sharing, knowledge management and enhanced enterprise mission IT solutions for federal, civilian and defence intelligence customers.

**Applied Intelligence** collects, manages and exploits information to enable government and commercial clients to reveal intelligence, maintain security, optimise performance and manage risk. Alongside its secure government-focused activities, the business is a supplier of information assurance products and services to the financial services and telecommunications sectors. Primary operations are in the UK, Denmark, Ireland and the US.



The Group has five principal reporting segments which align with the Group's strategic direction.

#### WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Geographically diverse and targeted portfolio of businesses.
- Balanced portfolio of products and services, including key intellectual property and focused investment in research and development.
- Group-wide mandated processes and an Operational Framework (see page 19).

#### HOW DOES THIS HELP TO CREATE VALUE?

The reporting segments allow focus on areas of expertise and recognise the growth areas of electronic systems and cyber and intelligence, increasing exports of products and services, the significant services element of the business and the Group's geographic spread. Transfer of best practice across businesses, within national security constraints, allows the Group to leverage appropriate skills and capabilities to meet the requirements of customers.

#### HOW IS IT MEASURED?

Sales by reporting segment ➞

Sales\* by reporting segment (%)



1	Electronic Systems	13
2	Cyber & Intelligence	7
3	Platforms & Services (US)	22
4	Platforms & Services (UK)	36
5	Platforms & Services (International)	22

\* Including share of equity accounted investments.



## PLATFORMS & SERVICES (US)

➞ See pages 48 to 52

Platforms & Services (US) comprises the Land & Armaments business, which includes a range of funded development activity and fixed-price production and services contracts, and the US-based Support Solutions business, which includes services, sustainment and systems integration activities which may be contracted over multi-year arrangements.

**Land & Armaments** is engaged in the design, development, production, support and upgrade of armoured combat vehicles, artillery systems, naval guns, missile launchers and munitions.

**US Combat Vehicles** focuses on the tracked and amphibious vehicles markets, servicing both US and international customers.

**Weapon Systems** focuses on naval weapons, munitions and artillery markets, servicing US, UK and international customers. Products include naval gun systems, artillery systems, munitions and missile launchers.

**BAE Systems Hägglunds** focuses on the tracked vehicle market for Swedish and international customers.

**FNSS**, BAE Systems' Turkish joint venture, produces and upgrades tracked and wheeled military vehicles for international customers.

**Support Solutions** is a major supplier of ship repair services to the US Navy and complex munitions facilities management for the Holston and Radford facilities. Other support activities in the US include fixed and rotary wing aircraft support services.



## PLATFORMS & SERVICES (UK)

➞ See pages 53 to 57

Platforms & Services (UK) is the focus for the Group's UK prime contracting platform and systems integration contracts, with a large order backlog of multi-year development, production and services contracts.

**Military Air & Information** includes programmes for the production of Typhoon combat and Hawk trainer aircraft, F-35 Lightning II sub-assembly manufacture, support for Typhoon, Tornado and Hawk aircraft, and development of next-generation Unmanned Air Systems and defence information systems. The Regional Aircraft business provides managed solutions for aircraft support services and engineering.

**Maritime** programmes include the manufacture of two new Queen Elizabeth Class aircraft carriers and Astute Class submarines for the Royal Navy, the design of the Successor submarine and Type 26 frigate, and in-service support.

**Combat Vehicles (UK)** is the UK-based armoured vehicle and support services business. The principal programme is for the design and manufacture of 60 Terrier combat engineer vehicles for the British Army.

**Munitions** focuses on the design, development and manufacture of a comprehensive range of products, servicing its main customer, the UK Ministry of Defence, as well as international customers. The business is the principal supplier of munitions to the British armed forces.



## PLATFORMS & SERVICES (INTERNATIONAL)

➞ See pages 58 to 61

Platforms & Services (International) comprises businesses in Saudi Arabia, Australia, India and Oman, as well as a 37.5% shareholding in MBDA.

In **Saudi Arabia**, the business provides operational capability support to the country's air and naval forces on UK/Saudi government-to-government contracts. Contracts include multi-year and fixed-price agreements, such as the Saudi British Defence Co-operation Programme.

In **Australia**, the business delivers production, upgrade and support programmes for the Australian government across the air, maritime and land domains. Services contracts include the provision of support and upgrades. Platforms contracts include naval ships, such as the Landing Helicopter Dock programme for the Navy. Contracts are often multi-year and fixed price.

In **India**, the Group continues to develop its 40% software joint venture, BAeHAL, and build on its long-standing relationship with Hindustan Aeronautics Limited, which is manufacturing Hawk aircraft under licence in India.

The business is developing its position in **Oman**, building on a long history of relationships with the Omani armed forces, with resulting orders placed with the relevant reporting segments.

**MBDA** is a leading global guided weapons manufacturer.



# DELIVERING SUSTAINABILITY

➔ See Sustainability summary section on pages 62 and 63



## WHAT IS IT?

BAE Systems manages the current impacts of its operations and products, and anticipates the future global business environment to ensure that it has processes in place to support the continued operation of the business.

## WHAT ARE BAE SYSTEMS' KEY STRENGTHS?

- Robust standards of workplace and product safety.
- A strong commitment to creating an inclusive workplace, where a diverse range of talented employees with broad skill sets and capabilities can deliver against global customer requirements.
- Programmes to manage the environmental impacts of the Group's operations and products.

## HOW DOES THIS HELP TO CREATE VALUE?

By managing the areas that have the most potential to affect the continued operation of the business, the Group is able to protect its operations and reputation.

## HOW IS IT MEASURED?

- ➔ See safety, diversity and inclusion, and environmental metrics on pages 114 to 117



The future workplace is likely to require workers with a breadth, depth and mix of skills. BAE Systems is one of the largest employers of apprentices in the manufacturing and engineering sector in the UK with 387 recruited during 2013 and a target to recruit more than 500 for 2014. The standards achieved by apprentices are extremely high as demonstrated by Pav Bhogal who picked up the 2013 Best Apprentice of the Year prize and Joanne Sharples who won an award for Outstanding Leadership at the New Talent Awards run by the North West Aerospace Alliance.

*Image: One of our apprentices at the Maritime – Submarines site in Barrow-in-Furness, Cumbria, UK*

# STRONG GOVERNANCE

➔ See Governance summary section on pages 64 and 65



The Board is responsible for the good governance of the Company. It sets the strategy, provides leadership to put this into effect, supervises management and reports to shareholders on its stewardship of the Company. The Board is formed of executive and independent non-executive directors, with non-executives comprising the majority of Board appointments. The Board is led by a non-executive Chairman who is responsible for the leadership of the Board and its effectiveness. The Chief Executive is responsible for the leadership, and the operational and performance management of the Company consistent with the strategy and business plan agreed by the Board.

The Company was compliant with the provisions of the UK Corporate Governance Code throughout 2013.

⬆ **From left to right:**  
Paul Anderson, Paula Rosput Reynolds, Carl Symon, Peter Lynas, Ian Tyler, Ian King, Sir Roger Carr, Jerry DeMuro, Chris Grigg, Harriet Green OBE, Nick Rose

## **Operational Framework – a stable foundation from which to deliver strategy and performance**

The Operational Framework is a document that sets out how business is done across BAE Systems. Reviewed on an annual basis by the Board, it is based on principles of good governance and details the values, policies and processes that are mandated across the Group, and how the Board delegates authority. The Board and its committees review compliance with the requirements of the Operational Framework on a regular basis.



# CHIEF EXECUTIVE'S REVIEW

Ian King, Chief Executive



## Overview

Overall, the Group delivered a solid performance in 2013, against the background of reduced government spending and tough market conditions. A proactive focus on costs and enhanced competitiveness allowed us to protect our margins across the majority of the business and we secured further contract wins in the US, Saudi Arabia and internationally. Our results also benefited from the satisfactory conclusion of price escalation negotiations with the Kingdom of Saudi Arabia, relating to an existing contract to supply Typhoon aircraft. We have continued to invest in research and technology and to develop business in international markets, and our strong order backlog and robust balance sheet as we enter 2014 are testament to our business health.

## US

In the US, budget uncertainties continued to impact government spending and procurement decisions throughout 2013. Sequestration measures resulting from the 2011 Budget Control Act either reduced or delayed many US activities. The Sequestration measures were targeting savings of approximately \$450bn (£272bn) from US defence budgets over a ten-year period, equivalent to an approximately 10% overall reduction. As certain areas of spending were protected from these reductions, such as military personnel accounts, the budgets funding much of the US defence industrial base are likely to be disproportionately impacted.

In addition to the Sequestration measures, in October, the political disagreements over the terms of a Continuing Resolution to cover the remainder of the 2013 fiscal year resulted in a partial US government shutdown. Following the brief shutdown, a Continuing Resolution was passed to fund the government until 15 January 2014. Whilst some disruption resulted from the shutdown, the impact to the Group's overall financial performance was not material.

In December, a bipartisan budget proposal for a two-year federal budget agreement was approved by Congress and signed into law. The resulting spending bill was approved in January 2014, far earlier in the fiscal cycle than in previous years, and whilst this legislation does not eliminate the Sequester completely, it does ease the significant and indiscriminate cuts that were expected in 2014 and 2015.

Given this environment, we based our planning assumptions on a progressive reduction in our US defence and security businesses of approximately 15% for 2013 and 2014. The recent budget developments return some clarity to near-term US government spending, although pressures to reduce spending and address the US deficit are expected to continue.



# “BAE SYSTEMS HAS BUILT STRONG MOMENTUM IN DELIVERING ON ITS STRATEGY.”

Nonetheless, there does seem to be clear support for some key programmes, including the F-35 Lightning II in which BAE Systems has a significant participation.

Some of the Group's US activities are not directly exposed to US government budgets. Our commercial electronics business continues to grow and we anticipate a rising contribution from US Foreign Military Sales. In December, the Republic of Korea finalised an agreement with the US government for BAE Systems to perform upgrades and systems integration for its fleet of more than 130 F-16 aircraft. This business opportunity, potentially worth approximately \$1.3bn (£0.8bn), is not yet included in our order backlog.

The Group also continues to be successful in winning competitive new business. In March, BAE Systems was awarded a five-year contract for the operation and management of the Holston Army Ammunition Plant in the US. In August, the Group was awarded an eight-year contract to maintain the readiness of Minuteman III intercontinental ballistic missiles in the US. In October, the Group received a US Army contract for Low-Rate Initial Production on the Paladin Integrated Management programme, a tracked artillery system. In December, the US Navy awarded BAE Systems a three-year, \$171m (£103m) contract to continue providing engineering and integration support to Trident II D-5 submarine-launched ballistic missiles.

In Land & Armaments, we have refocused the business on core markets and our capabilities in combat vehicles, amphibious vehicles, artillery systems and naval surface fires. We have also rationalised the land facilities more broadly, reducing 51 sites to 15 centres. Against a background of substantially reduced demand, we are working to protect key industrial capabilities and margins.

Performance issues recently emerged in the multi-year Radford Army Ammunition Plant support contract. Customer volume reductions require this contract to be restructured and we aim to renegotiate an agreement on this key military capability.

## UK

Notwithstanding the continued pressure on many areas of government spend in the UK, our business is in good shape and the outlook remains stable. Much of the Group's UK business is concentrated on a small number of large programmes where multi-year contracts provide good visibility, as evidenced by the large UK order backlog.

In the air sector, the first Tranche 3 Typhoon has flown and we have recently been able to reveal previously classified footage of the successful flight trials of the Taranis unmanned aerial vehicle. Deliveries of Typhoon continued to European partner nations.

In the maritime sector, in November, BAE Systems reached agreement with the UK government on measures to enable the implementation of a restructuring of its UK naval ships business. The measures included a restructuring of the Queen Elizabeth Class aircraft carrier contract to accommodate changes to the programme and to reflect its increased maturity. In addition, a programme to build three Offshore Patrol Vessels for the Royal Navy was announced. Consultation with trade union and employee representatives commenced regarding the rationalisation of the naval ships business to address anticipated reduced workload levels beyond the current high volume of activity on the aircraft carrier programme. Contracts to enact this overall agreement are forecast to be finalised in 2014.

Good progress has been made in defining the Type 26 frigate programme to replace Type 23 vessels, with over 600 employees now working on the contract.

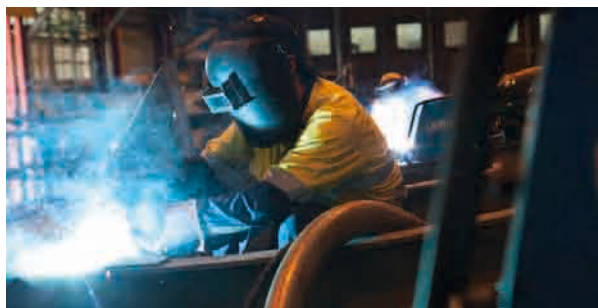
Submarines activity continues to progress on the Astute Class programme and workload is increasing on the Successor programme in preparation for a possible replacement of the Vanguard Class boats.

In September 2014, Scotland will hold an independence referendum. The decision on independence from the UK is a matter for the people of Scotland. However, BAE Systems has significant interests and employees in Scotland, and it is clear that continued union offers greater certainty and stability for our business. In the event that Scotland voted to become independent, we would need to discuss the way forward with the Ministry of Defence and UK government, and work with them to deliver the best solution in those circumstances.

Our Applied Intelligence business (formerly BAE Systems Detica), which is well-positioned in the fast-growing commercial cyber security sector, has substantially increased its order backlog.

In February 2013, Applied Intelligence and Vodafone agreed the formation of a five-year partnership to provide businesses with a range of advanced mobile communications security products and services, initially focused on smartphones and tablets.

Applied Intelligence signed, in September, a framework contract with the Foreign & Commonwealth Office (FCO) to deliver service management integration services across the FCO's global IT estate.



### Peter Leahy (Project Manager, Air Warfare Destroyer) – weathering the storm

To overcome the lack of shipbuilding skills in Williamstown, Australia, Peter Leahy set about re-skilling the team on the latest methods, as well as importing skills from BAE Systems in the UK. This single-minded focus to work efficiently and to deliver high-quality results paid off with at least a 30% reduction in costs. This impressive turnaround also helped to secure future work for the shipyard.

### John Emmons (Senior Lead Full Motion Video Analyst)

#### – making more moments

With BAE Systems' activity-based intelligence, a computer-assisted problem solving methodology, John Emmons and his team in the US are able to streamline the process of digging through vast amounts of heavily layered data to reveal patterns and anomalies, thought of as intelligence treasures by intelligence analysts studying the behaviour of potential threats. Our activity-based intelligence technology helps to make big data small.



### Non-UK/US order intake<sup>1</sup> (£bn)

2013	9.3
2012	11.2
2011	4.8
2010	4.3

### Non-UK/US order intake<sup>1</sup> (% of total)

2013	48
2012	50
2011	29
2010	26

### International

Building on the strong international order intake performance in 2012, a further £9.3bn of non-UK/US order intake<sup>1</sup> was achieved in the year.

While the opportunity was not included in our business plans, we were disappointed that the government of the United Arab Emirates (UAE) elected not to proceed with proposals regarding a range of defence and security capabilities including the potential supply of Typhoon aircraft. Nonetheless, the aircraft fully met the customer's exacting requirements and BAE Systems stands ready to work with the UAE to address any future requirements.

We continue to pursue a number of opportunities in international markets. Building on the successful sale of Typhoon and Hawk aircraft in Saudi Arabia and Oman, a number of military aircraft-related opportunities have been identified.

Aircraft deliveries on the Salam Typhoon programme to Saudi Arabia re-commenced in April.

In February 2014, the governments of the UK and Kingdom of Saudi Arabia agreed price escalation terms relating to the Typhoon aircraft under the Salam programme and these have been reflected in contractual arrangements between the UK government and BAE Systems. The terms of the agreement are broadly consistent with the Group's prior trading outlook for 2013. Cash settlement is expected to follow this pricing agreement, commencing in the early part of 2014. The Group believes this to be an equitable outcome for all parties and is pleased to conclude this negotiation which builds on the long-standing relationship with this much-valued customer.

The significant flow of new contract awards with the Kingdom of Saudi Arabia continued through 2013. Contracts valued at approximately £6.4bn have been signed in the year, including a five-year, £1.8bn follow-on support contract on the Salam Typhoon programme and a further £1.5bn contract for Tornado aircraft upgrades and weapons under the Saudi British Defence Co-operation Programme.

In December, the Swedish government exercised its option to buy 102 more BvS10 all-terrain vehicles in an order worth approximately \$120m (£72m). In December, FNSS, BAE Systems' Turkish joint venture, received a \$360m (£217m) contract from the land forces of a Middle Eastern country for the upgrade of M113 tracked armoured personnel carriers.

The Group was disappointed that the Canadian government decided to cancel its Close Combat Vehicle programme. However, we continue to pursue opportunities for combat vehicles with the Swedish CV90 tracked infantry fighting vehicle forming the basis for a current bid in Denmark. In addition, BAE Systems is working with Polish Defence Holdings to address substantial replacement vehicle requirements expected to emerge later this decade in Poland.

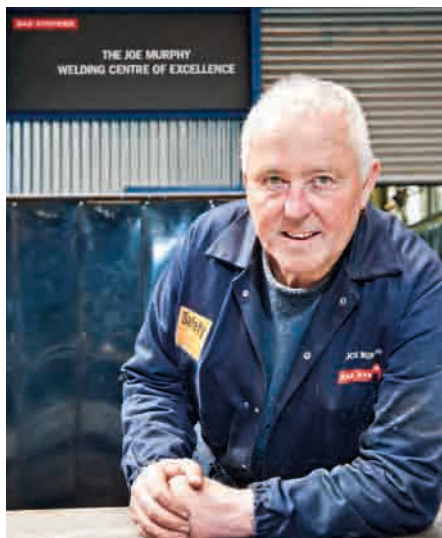
BAE Systems continues to develop opportunities for Bradley fighting vehicles in Saudi Arabia and, more recently, another emerging requirement in the region.

The success in South Korea on the F-16 upgrade programme is a significant competitive win.

<sup>1</sup> Including equity accounted investments.

### Joe Murphy MBE (Welding Trainer) – the Queen's welder

Working for the past 40 years in Barrow-in-Furness, UK, Joe has helped to produce highly complex submarines for the Royal Navy. Battling temperatures of up to 120 degrees in a confined space is an art form. Joe Murphy MBE passes on his skills, work ethic and tenacity to the next generation of welders being trained in the Joe Murphy Welding Centre of Excellence.



### Saeed AlGhamdi (Quality Manager, Tornado) – from apprentice to expert

Saeed AlGhamdi started as an apprentice 13 years ago and is now part of a quality control taskforce servicing and maintaining Tornado aircraft in Saudi Arabia. His proudest moment has been to re-design part of Tornado's rudder, preventing damage to the part in servicing, resulting in cost and time savings which earned him a BAE Systems Chairman's Award.



### Balance sheet and capital allocation

The Group's balance sheet continues to be managed conservatively in line with our policy to retain an investment grade credit rating and to ensure operating flexibility.

Consistent with this approach, the Group expects to continue to meet its pension obligations, pursue organic investment opportunities, pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Investment in value-enhancing acquisitions will be considered where market conditions are right and where they deliver on the Group's strategy.

In February 2013, the Group initiated a share repurchase programme of up to £1bn over three years. Implementation of the programme has been influenced by the timing of a satisfactory resolution of the Salam Typhoon price escalation negotiations. As at 19 February 2014, BAE Systems had purchased 65 million shares for approximately £271m under the programme.

Consistent with previous share buybacks, the Group has agreed with the trustees of its UK pension schemes to pay £340m of cash contributions into the schemes over the three-year period of a full implementation of the share repurchase programme.

### Inspired Work

Our employees have a key role to play in the success of our business. Their contribution is never more important than when the Group is facing significant market pressures. BAE Systems' people have continued to rise to the challenge, demonstrating their commitment to meeting the needs of customers with increasingly more cost-effective and innovative solutions. There are many examples of our people's inspired work highlighted across this publication.

### Responsible conduct

The way the Group undergoes its business is equally as important as the delivery of the output and great emphasis continues to be placed on business conduct throughout the Group.

The safety of our employees and those using our products is critical to our business, a key priority and a fundamental responsibility for the Group. Regrettably, there were two work-related employee fatalities in 2013. Each accident is thoroughly investigated and lessons learnt are applied across the Group. We continue to drive safety improvements and achieved a 17% reduction in the Recordable Accident Rate, which represents the sixth consecutive year of improvement.

### Board and management

Sir Richard Oliver stepped down as Chairman of the Group in February 2014 and has been succeeded by Sir Roger Carr. Sir Richard has been a tremendous supporter of our Company and our industry over the last decade and has led wide-ranging cultural and governance changes within the Company. He leaves with our best wishes for the future.

I am delighted to welcome Sir Roger Carr as Chairman. Sir Roger has two decades of Board-level experience leading international businesses and most recently was Chairman of Centrica plc and President of the Confederation of British Industry, the UK's main business lobbying group. He is also Deputy Chairman and Senior Independent Director of the Court of the Bank of England and a member of the UK Prime Minister's Business Advisory Group.

Jerry DeMuro took up his role as President and Chief Executive Officer of BAE Systems, Inc. from 1 February 2014. Jerry joins the Group from General Dynamics and succeeded Linda Hudson, who announced her intention to retire from the Company in August. He is also an executive director of BAE Systems plc and a member of BAE Systems' Executive Committee.

On 5 February 2014, Tom Arseneault, formerly Executive Vice President, Product Sectors, was appointed as Chief Operating Officer for BAE Systems, Inc. and Dave Herr, formerly Executive Vice President, Service Sectors, for BAE Systems, Inc. and Executive Committee member, will retire from the Group on 31 March 2014.

In January 2014, Claire Diver joined the Group from Xstrata plc as Group Communications Director and a member of the Executive Committee. She replaced Charlotte Lambkin who left the Group in September.

### Summary and outlook

Budget pressures in some of the Group's larger markets are expected to prevail but BAE Systems has a broad-based portfolio. Good progress has been made to grow the order backlog, providing a solid basis for growth over the medium term. The Group's continued focus on cost and targeted investment aims to enhance competitiveness and affordability for the benefit of customers and sustain attractive returns for shareholders.

Ian King, Chief Executive

# EXECUTIVE COMMITTEE OBJECTIVES

The Executive Committee sets annual objectives which focus on deliverables in support of delivery of both short-term results and the overall long-term strategy. Performance against the 2013 objectives is discussed below. Recognising the strong momentum in delivery of the strategy, the objectives for 2014 remain unchanged.

➞ See the Group Strategic Framework on pages 7 and 8

➞ See the Group's Key Performance Indicators on pages 26 to 28

<p><b>2013 objective</b></p> <p><b>FINANCIAL PERFORMANCE</b></p> <p>Meet 2013 financial targets</p> <p>➞ See page 12 for more information</p>	<p><b>2013 performance</b></p> <p>Underlying earnings<sup>1</sup> per share was above threshold, but below target. Order intake<sup>2</sup> was on target. Net cash/(debt)<sup>3</sup> was above target, but below stretch.</p> <p>➞ See Annual remuneration report on page 94</p> <p>1 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts). 2 Including share of equity accounted investments. 3 See note 10 to the Group accounts.</p>	<p><b>2014 objective</b></p> <p>Meet 2014 financial targets</p>
<p><b>2013 objective</b></p> <p><b>CUSTOMER FOCUS AND PROGRAMME EXECUTION</b></p> <p>Continued focus on improving customer satisfaction and programme execution</p> <p>➞ See pages 10 and 11 for more information</p>	<p><b>2013 performance</b></p> <p>The Group continued to deliver on its commitments to its customers with good programme execution reflected in an overall improvement in outturn margin across its major programmes.</p>	<p><b>2014 objective</b></p> <p>Continued focus on improving customer satisfaction and programme execution</p>
<p><b>2013 objective</b></p> <p><b>RESPONSIBLE BEHAVIOUR</b></p> <p>Progress towards recognised leading positions</p> <p>➞ See page 13 for more information</p>	<p><b>2013 performance</b></p> <p>Group targets for safety and environment were met. All Executive Committee members met their individual targets for diversity and inclusion.</p> <p>➞ See Annual remuneration report on page 94</p>	<p><b>2014 objective</b></p> <p>Progress towards recognised leading positions</p>
<p><b>2013 objective</b></p> <p><b>ENGAGEMENT</b></p> <p>Inspire and engage our people to deliver success</p> <p>➞ See page 114 for more information</p>	<p><b>2013 performance</b></p> <p>Strategy workshops and supporting materials have been rolled out to employees across the businesses during the year to help employees to recognise their role in delivering the Group's strategic objectives.</p>	<p><b>2014 objective</b></p> <p>Inspire and engage our people to deliver success</p>



**2013 objective****ELECTRONIC SYSTEMS**

Be agile, sustain revenues and deliver strong bottom line performance

➔ See pages 38 to 42 for more information

**2013 performance**

The business achieved important contract wins in strategically important areas, including in the electronic warfare and commercial aircraft electronics markets, and on the US Army's Joint Effects Targeting System programme. Return on sales was maintained around 14%.

**2014 objective**

Be agile, sustain revenues and deliver strong bottom line performance

**2013 objective****CYBER & INTELLIGENCE**

Enhance and grow our positions in cyber, intelligence and security

➔ See pages 43 to 47 for more information

**2013 performance**

Whilst the Intelligence & Security business was significantly impacted by US budget pressures and the partial government shutdown, it has continued to build a leadership position in activity-based intelligence and was awarded a three-year follow-on contract to the Counter-Improvised Explosive Device programme. Applied Intelligence has been awarded strategically important contracts, including with Vodafone for secure mobile services and with the Foreign & Commonwealth Office for managed IT services. The Applied Intelligence order backlog grew by 60% in 2013.

**2014 objective**

Enhance and grow our positions in cyber, intelligence and security

**2013 objective****PLATFORMS & SERVICES (US)**

Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector

➔ See pages 48 to 52 for more information

**2013 performance**

In Land & Armaments, cost reduction actions continued and return on sales increased to 9.3%. There was a production order from the US Army on Paladin Integrated Management and export awards for BvS10 vehicles and M113 upgrades. Support Solutions won multi-year contracts in the US for munitions facilities management and support to ballistic missiles. A Letter of Agreement for upgrades and systems integration on F-16 aircraft for South Korea was finalised. Performance was impacted by US budget pressures, as well as charges taken on the Radford Army Ammunition Plant contract, commercial shipbuilding activity and not being awarded follow-on options on the US Navy aircraft maintenance contract.

**2014 objective**

Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector

**2013 objective****PLATFORMS & SERVICES (UK)**

Deliver sustainably profitable through-life businesses in the air, maritime and combat vehicles sectors

➔ See pages 53 to 57 for more information

**2013 performance**

Strong programme performance delivered a return on sales of 12.8%. In air, work progressed on the Omani Typhoon and Hawk aircraft contract, and the first Typhoon Tranche 3 aircraft was delivered to the Royal Air Force. In maritime, the business reached agreement in principle with the UK's Ministry of Defence on the restructuring of the UK naval ships business. Good progress was made on the Type 26 frigate and Successor submarine design contracts.

**2014 objective**

Deliver sustainably profitable through-life businesses in the air, maritime, combat vehicles and munitions sectors

**2013 objective****PLATFORMS & SERVICES (INTERNATIONAL)**

Grow our Platforms & Services (International) business

➔ See pages 58 to 61 for more information

**2013 performance**

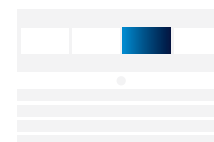
In Saudi Arabia, on the Salam Typhoon programme, aircraft deliveries resumed, a five-year support contract for £1.8bn was received and price escalation terms were agreed. On the Saudi British Defence Co-operation Programme, £1.5bn of orders were received for Tornado upgrades and weapons procurement. In Australia, good progress was made on the Landing Helicopter Dock programme and additional blocks were contracted on the Air Warfare Destroyer programme. The business was also awarded a five-year contract to continue to support Royal Australian Air Force Hawk aircraft.

**2014 objective**

Grow our Platforms & Services (International) business

# KEY PERFORMANCE INDICATORS

Business model – page 9



The Board uses a range of quantitative financial and non-financial performance indicators, reported on a periodic basis, to monitor the Group's performance against its Total Performance and Executive Committee objectives. Executive directors' remuneration is linked to certain of these measures.

## Financial Performance

The Group sets challenging financial targets through its Integrated Business Planning process to maximise financial performance and drive long-term shareholder value.

### Funded order intake<sup>1,3</sup> (£bn)

# £19.3BN

★ Part of the executive directors' 2013 annual incentive

✓ Target<sup>7</sup> achieved

➔ See page 94

2013	19.3
2012	22.3
2011	16.6
2010	16.3
2009	21.6

#### Definition

Funded order intake represents the value of funded orders received from customers in the year.

Funded order intake is a measure of in-year performance and supports future years' sales performance.

#### Comment

Funded order intake<sup>3</sup> benefited from long-term support contracts and further weapons packages in the Kingdom of Saudi Arabia secured during the year, and order backlog<sup>3</sup> was sustained at over £42bn. Non-UK/US funded order intake<sup>3</sup> was £9.3bn (2012 £11.2bn), 48% (2012 50%) of total funded order intake<sup>3</sup>.

### Sales<sup>1,3</sup> (£bn)

# £18.2BN +2%

2013	18.2
2012	17.9
2011	19.2
2010	22.3
2009	21.8

#### Definition

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

#### Comment

Volume reductions in the US businesses and, in particular, at Land & Armaments were more than offset by the resumption of Typhoon aircraft deliveries and trading of the price escalation on the Salam programme.

➔ See sales<sup>3</sup> bridge chart on page 33

➔ See Executive Committee objectives on page 24

➔ See Group financial performance on page 32

➔ See Segmental performance on page 36

1 2012 re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7 to the Group accounts).

2 2012 restated on adoption of the revised IAS 19, Employee Benefits (see page 126). 2011 and prior years have not been restated.

3 Including share of equity accounted investments.

4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

5 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).



Underlying EBITA<sup>1,2,4</sup> (£m)**£1,925M +3%**

2013	1,925
2012	1,862
2011	2,025
2010	2,179
2009	2,151

**Definition**

Underlying EBITA excludes amortisation and impairment of intangible assets, finance costs and taxation expense, and non-recurring items (profit/loss on disposal of businesses and regulatory penalties).

Underlying EBITA is used by the Group for internal performance analysis as a measure of operating profitability that is comparable over time.

**Comment**

Underlying EBITA<sup>4</sup> increased by 3%, to £1,925m, giving a return on sales of 10.6% (2012 10.4%).

Underlying earnings<sup>1,2,5</sup> per share (pence)**42.0P +9%**

2013	42.0
2012	38.7
2011	39.7 45.6
2010	39.8
2009	39.1

■ R&D tax benefit<sup>8</sup>  
 ■ Excluding R&D tax benefit<sup>8</sup>

★ Part of the executive directors' 2013 annual incentive

**Definition**

Underlying earnings represent profit for the year attributable to equity shareholders excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).

Underlying earnings per share provides a measure of shareholder return that is comparable over time.

✗ Target<sup>7</sup> not achieved

➔ See page 94

**Comment**

Underlying earnings<sup>5</sup> per share benefited from the margin recognition on the Salam Typhoon programme and the lower tax rate of 22%.

➔ See underlying earnings<sup>5</sup> per share bridge chart on page 33

Operating business cash flow<sup>6</sup> (£m)**£147M**

2013	147
2012	2,692
2011	634
2010	1,187
2009	1,595

**Definition**

Operating business cash flow represents net cash flow from operating activities after capital expenditure (net) and financial investment and dividends from equity accounted investments.

Operating business cash flow is the measure used to assess the operating cash generation of the Group.

**Comment**

As anticipated, advances received in 2012 on the Omani Typhoon and Hawk, Saudi training aircraft and Saudi Tornado upgrade programmes are being utilised. Advances were also consumed in the year on the European Typhoon Tranche 2 programme. Provisions created in previous years were utilised on the Oman Offshore Patrol Vessel contract and on rationalisation. The £131m Trinidad and Tobago termination settlement was paid during the year.

➔ See Executive Committee objectives on page 24

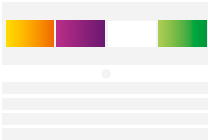
➔ See Group financial performance on page 32

➔ See Segmental performance on page 36

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

7 The target is the Group's budget for the year, which represents the first year of the five-year Integrated Business Plan (see page 69).

8 Underlying earnings per share in 2011 included a 5.9p tax benefit arising as a result of an agreement with the UK tax authorities addressing a number of items, including research and development tax credits.



Customer Focus

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

Customer satisfaction

<b>Definition</b> Customer satisfaction surveys are used by the businesses 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.	<b>Performance</b> The Group focuses on improving customer satisfaction across its major contracts.  Customer satisfaction metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.	<b>Comment</b> Recognising the diversity of customers and activities across the Group, customer satisfaction is managed at a business level.  Customer satisfaction is a metric used by the businesses at monthly Contract Reviews prepared under Lifecycle Management.
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Programme Execution

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

Programme margin variation

✓ Target achieved

<b>Definition</b> Programme margin variation measures outturn projections of, and movements in, margin of key customer-funded projects. It provides an indicator of the Group’s ability to effectively manage major programmes.	<b>Performance</b> The Group focuses on improving programme execution across its major contracts.  Programme margin variation metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.	<b>Comment</b> The data for the programme margin variation metric included 99 contracts reported in Contract Reviews prepared under Lifecycle Management, representing 63% of the Group’s funded order backlog.
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Responsible Behaviour

Responsible Behaviour is fundamental to the business. The Group’s Code of Conduct provides guidance on the principles and standards of business conduct expected of all employees. Together with the Group’s Responsible Trading Principles, the Code of Conduct underpins the Group’s business activities.

Recordable Accident Rate

★ Part of the executive directors’ 2013 annual incentive

✓ Target achieved

➡ See page 94

Definition	Performance	Comment						
The number of injuries per 100,000 employees is monitored, and actions taken to minimise the risk to the Group's employees and its operations, and drive continual performance improvement.	<p><b>Recordable Accident Rate*</b> (per 100,000 employees)</p> <table><tr><td>2013</td><td>965</td></tr><tr><td>2012</td><td>1,162</td></tr><tr><td>2011</td><td>1,669</td></tr></table>	2013	965	2012	1,162	2011	1,669	The Recordable Accident Rate, which focuses on the number of accidents, is the principal metric used by the Group's businesses to monitor performance in safety and drive improvements in accident prevention. The Group also uses a five-level Safety Maturity Matrix to help its businesses around the world work towards consistently high safety standards.
2013	965							
2012	1,162							
2011	1,669							

\* See Deloitte LLP assurance statement on page 119.

➡ See Executive Committee objectives on page 24

➡ See Sustainability summary on page 62

➡ See Segmental performance on page 36

# RISK MANAGEMENT

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

## Board

The Board has overall responsibility for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives, and ensuring that risks are managed effectively across the Group.

Risk is a regular agenda item at Board meetings and the Board reviews risk as part of its annual strategy review process. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

The Board delegates certain risk management activities to the Audit and Corporate Responsibility committees as follows.

### Audit Committee

The Audit Committee monitors the Group's key risks identified by the risk assessment processes and reports its findings to the Board twice a year. It is also responsible 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.

### Corporate Responsibility Committee

The Corporate Responsibility Committee monitors the Group's performance in managing the Group's significant non-financial risks, including those arising in respect of business conduct, health and safety, and the environment, and reports its findings to the Board on a regular basis.

## Approach

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

The Group is committed to the protection of its assets, which include human, intellectual and physical property, and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

Reporting within the Group is structured so that key issues are escalated through the management team and ultimately to the Board where appropriate. The underlying principles

of the Group's risk management policy are that risks are monitored continuously, associated action plans reviewed, appropriate contingencies provisioned and this information reported through established management control procedures.

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.

## Financial and non-financial risks

Financial risks expose the Group to potential costs which are quantifiable on the basis that their probability and impact can be adequately understood and related to the financial statements.

Non-financial risks cannot readily be assessed in financial terms and, therefore, cannot be reflected reliably in the financial statements.

## Process

### Businesses

The responsibility for risk identification, analysis, evaluation and mitigation rests with the line management of the businesses. They are also responsible for reporting and monitoring key risks in accordance with established processes under the Group's Operational Framework.

The Group's risk management process is set out in the Risk Management Policy, a mandated policy under the Operational Framework, and, in respect of projects, in the Lifecycle Management Framework, a core business process under the Operational Framework. Further guidance is provided by a Risk Management Maturity self-assessment tool.

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.

Project risks are reported and monitored in Group-mandated format Contract Review Packs, which are reviewed by management at monthly Contract Reviews. The financial performance of projects is reported and monitored using Contract Status Reports, which form part of the Contract Review Pack. These include programme margin metrics, which are reviewed regularly by the Executive Committee and Board (see KPI on page 28). Project margin is recognised after making suitable allowances for technical and other risks related to performance milestones yet to be achieved.

In addition, every six months, the businesses complete an Operational Assurance Statement (OAS), which is a mandated policy under the Operational Framework. The OAS is in two parts: a self-assessment of compliance with the Operational Framework; and a report showing the key financial and non-financial risks for the relevant business. Together with 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.

### Executive Committee

The key financial and non-financial risks identified by the businesses 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.

Management responsibility for the management of the Group's most significant non-financial risks is determined by the Executive Committee. The OAS and Non-financial Risk registers are reviewed regularly by the Executive Committee to monitor the status and progression of mitigation plans, and these key risks are reported to the Board on a regular basis.

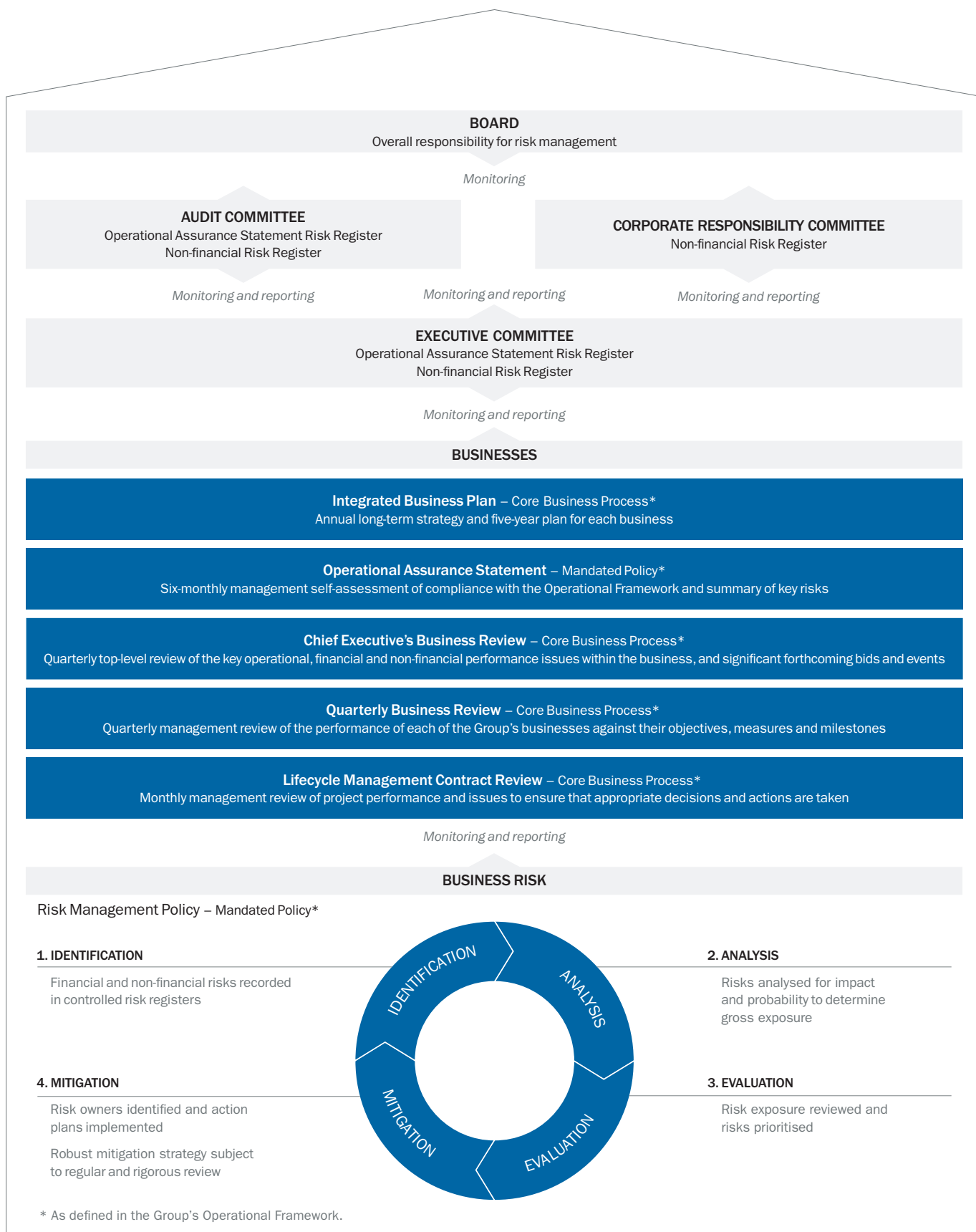
## Principal risks

Risks are identified as principal based on the likelihood of occurrence and potential impact on the Group. The principal risks identified by the Group using the policies and processes explained above during the year are summarised on page 31.

➞ For more information on the activities of the Board and its committees see pages 69 to 81

➞ For more information on the Group's business processes and mandated policies see page 69

## How BAE Systems manages risk:



➞ For more information on the Group's Operational Framework see page 19

# PRINCIPAL RISKS SUMMARY

## Defence spending

The Group is dependent on defence spending.

HIGH IMPACT

MEDIUM IMPACT

## Government customers

The Group's largest customers are governments.

HIGH IMPACT

MEDIUM IMPACT

## Global market

The Group operates in a global market.

HIGH IMPACT

MEDIUM IMPACT

## Contract award timing

The Group is dependent on the timing of award of defence contracts.

HIGH IMPACT

MEDIUM IMPACT

## Large contracts

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

HIGH IMPACT

MEDIUM IMPACT

## Fixed-price contracts

The Group has fixed-price contracts.

HIGH IMPACT

MEDIUM IMPACT

## Component availability, subcontractor performance and key suppliers

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

HIGH IMPACT

MEDIUM IMPACT

## Laws and regulations

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

HIGH IMPACT

MEDIUM IMPACT

## Competition

The Group's business is subject to significant competition.

HIGH IMPACT

MEDIUM IMPACT

## Pension funding

The Group has an aggregate funding deficit in its defined benefit pension schemes.

HIGH IMPACT

MEDIUM IMPACT

## Export controls and other restrictions

The Group is subject to export controls and other restrictions.

HIGH IMPACT

MEDIUM IMPACT

## Acquisitions

The anticipated benefits of acquisitions may not be achieved.

HIGH IMPACT

MEDIUM IMPACT

## Consortia and joint ventures

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

HIGH IMPACT

MEDIUM IMPACT

## Exchange rates

The Group is exposed to volatility in currency exchange rates.

HIGH IMPACT

MEDIUM IMPACT

## Cyber security

The Group could be negatively impacted by information technology security threats.

HIGH IMPACT

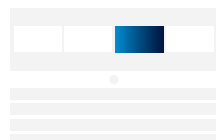
MEDIUM IMPACT

➔ FURTHER INFORMATION ON EACH RISK CAN BE FOUND ON PAGES 106 TO 111 OF THE DIRECTORS' REPORT

# GROUP FINANCIAL PERFORMANCE

Peter Lynas, Group Finance Director

Business model – page 9



## Financial highlights

- Sales<sup>3</sup> increased by 2%
- Underlying EBITA<sup>4</sup> increased by 3% to £1,925m
- Underlying earnings<sup>5</sup> per share increased by 9%
- Order backlog<sup>3,6</sup> maintained, with non-UK/US order intake<sup>3</sup> of £9.3bn
- Operating business cash inflow<sup>8</sup> of £147m
- Net debt<sup>9</sup> of £699m
- Goodwill impairment charge of £865m relating to the US Intelligence & Security and Land & Armaments businesses
- £212m expended in 2013 on the three-year share repurchase programme
- Total dividend increased by 3% to 20.1p

## Critical accounting policies

Certain of the Group's principal accounting policies are considered by the directors to be critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements.

➔ See page 126

## Accounting change

With effect from 1 January 2013, the Group has adopted the revised International Accounting Standard 19, Employee Benefits. This replaces interest cost on gross pension liabilities and expected return on gross pension assets with a finance cost on the net pension deficit calculated using the rate currently used to discount defined benefit pension liabilities and requires certain administrative costs to be included within underlying EBITA<sup>4</sup>. Comparative financial information has been restated accordingly.

➔ See page 126 and note 23 to the Group accounts on page 162

1 On adoption of the revised International Accounting Standard 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7 to the Group accounts).

3 Including share of equity accounted investments.

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

5 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).

Sales <sup>3</sup> bridge (£bn)		KPI
2013		18.2
Other	(0.1)	
Salam Typhoon trading	1.0	
US defence volumes	(0.6)	
2012		17.9

➔ See note 1 to the Group accounts on page 130

Underlying earnings <sup>5</sup> per share bridge (pence)		KPI
2013		42.0
Other	(1.6)	
Salam Typhoon trading	6.3	
Support Solutions charges	(1.2)	
US defence volumes	(1.5)	
Share buyback	0.2	
Tax rate	1.1	
2012		38.7

➔ See note 8 to the Group accounts on page 140

### Income statement

**Sales<sup>3</sup>** increased by 2% to £18,180m (2012 £17,905m). Volume reductions in the US businesses and, in particular, at Land & Armaments were more than offset by the resumption of Typhoon aircraft deliveries and trading of the price escalation on the Salam programme. The movements driving this increase are illustrated in the bridge chart above.

**Underlying EBITA<sup>4</sup>** increased by 3%, to £1,925m (2012 £1,862m), giving a return on sales of 10.6% (2012 10.4%).

**Profit on disposal of businesses** of £6m includes the disposal of the Commercial Armored Vehicles business, which was part of Land & Armaments. The profit of £103m in 2012 included the disposals of Safety Products and Safariland, and assets comprising the Tensylon business, which were also Land & Armaments businesses.

**Amortisation of intangible assets** is £37m lower at £189m mainly reflecting intangible assets on programmes in the Land & Armaments business becoming fully amortised in 2012.

**Impairment of intangible assets** of £887m includes goodwill impairment of £865m relating to the US Intelligence & Security and Land & Armaments businesses as a result of an increase in the Group's post-tax weighted average cost of capital and an estimate of reductions in US defence spending. The £86m charge in 2012 mainly related to the Safariland and Tensylon businesses sold in 2012, and the Commercial Armored Vehicles business sold in 2013.

**Finance costs<sup>3</sup>** were £392m (2012 £410m). The underlying interest charge, which excludes pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements, is £25m lower at £179m. A full year of interest on the £400m of debt issued in June 2012 is more than offset by the lower level of net present value charges on long-term liabilities in 2013.

**Taxation expense<sup>3</sup>** reflects an effective tax rate of 22% (2012 24%). The calculation of the effective tax rate is shown in note 6 to the Group accounts on page 137. The underlying tax rate for 2014 is expected to be between 21% and 23%, with the final number dependent on the geographical mix of profits.

### Summary income statement

	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
<b>Sales<sup>3</sup></b>	<b>18,180</b>	17,905
<b>Underlying EBITA<sup>4</sup></b>	<b>1,925</b>	1,862
Return on sales	10.6%	10.4%
Profit on disposal of businesses	6	103
<b>EBITA</b>	<b>1,931</b>	1,965
Amortisation of intangible assets	(189)	(226)
Impairment of intangible assets	(887)	(86)
Finance costs <sup>3</sup>	(392)	(410)
Taxation expense <sup>3</sup>	(287)	(284)
<b>Profit for the year</b>	<b>176</b>	959

### Earnings per share

	2013	Restated <sup>1</sup> 2012 <sup>2</sup>
<b>Underlying earnings<sup>5</sup> per share</b>	<b>42.0p</b>	38.7p
Basic earnings per share	5.2p	29.3p
<b>Exchange rates – average</b>	<b>2013</b>	2012
£/\$	1.564	1.585
£/€	1.178	1.233
£/A\$	1.623	1.531

### Earnings per share

**Underlying earnings<sup>5</sup> per share** was 42.0p, an increase of 9% on 2012. The movements driving this increase are illustrated in the bridge chart above.

**Basic earnings per share**, in accordance with International Accounting Standard 33, Earnings per Share, was 5.2p (2012 29.3p). The reduction on 2012 mainly reflects the £887m of impairment charges taken in 2013 (2012 £86m) which are excluded from underlying earnings<sup>5</sup> per share.

6 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.

7 2012 excludes the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net (debt)/cash.

8 See note 9 to the Group accounts.

9 See note 10 to the Group accounts.



## Maturity of the Group's borrowings (£bn)

2013	2.9
2014	2.5
2015	2.1
2016	1.9
2017	1.9
2018	1.9
2019	1.2
2020	1.2
2021	0.9
2022	0.5
2023	0.5

➔ See note 21 to the Group accounts on page 160

## Cash flow

Cash inflow from operating activities<sup>7</sup> was £205m (2012 £2,916m). As anticipated, advances received in 2012 on the Omani Typhoon and Hawk, Saudi training aircraft and Saudi Tornado upgrade programmes are being utilised. Advances were also consumed in the year on the European Typhoon Tranche 2 programme. Provisions created in previous years were utilised on the Oman Offshore Patrol Vessel contract and on rationalisation. The £131m Trinidad and Tobago termination settlement was paid during the year.

Cash contributions in respect of deficit funding, over and above service costs to the UK and US pension schemes, were £389m (2012 £507m).

There was an outflow from **net capital expenditure and financial investment** of £153m (2012 £293m).

**Dividends received from equity accounted investments**, primarily Gripen and MBDA, totalled £95m (2012 £94m).

**Interest** payments were £19m higher at £166m reflecting a full year of interest on the £400m of debt issued in June 2012.

**Taxation** payments were £23m higher primarily reflecting tax refunds in 2012 following the 2011 UK Research & Development tax settlement, partly offset by lower US taxable profits and timing differences on US tax payments.

Net cash inflow in respect of **acquisitions and disposals** of £96m in 2012 mainly comprised the disposals of Safety Products and Safariland, and assets comprising the Tensylon business.

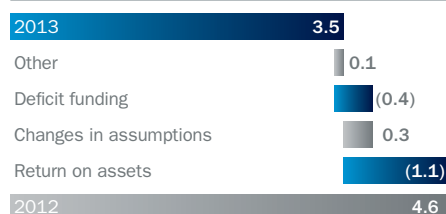
The **net purchase of own shares** of £212m represents 51.6 million shares purchased under the buyback programme (including transaction costs).

As a consequence of movements in US dollar and Euro exchange rates during the year, there has been a **cash outflow from matured derivative financial instruments** of £47m (2012 £119m) from rolling hedges on balances with the Group's subsidiaries and equity accounted investments.

**Net debt (as defined by the Group)**<sup>9</sup> is £699m, a net outflow from the net cash<sup>9</sup> position of £387m at the start of the year. Cash and cash equivalents of £2,222m (2012 £3,355m) are held primarily for the share repurchase programme, pension deficit funding, payment of the 2013 final dividend, repayment of £0.4bn of debt securities maturing in 2014 and management of working capital. The maturity profile of the borrowings component of net debt<sup>9</sup> is illustrated in the chart above. Details of the Group's objectives and policies regarding net (debt)/cash<sup>9</sup> are provided in note 28 to the Group accounts on page 175.

Reconciliation of cash flow from operating activities <sup>7</sup> to net (debt)/cash (as defined by the Group) <sup>9</sup>	2013 £m	2012 £m
<b>Cash flow from operating activities<sup>7</sup></b>	<b>205</b>	<b>2,916</b>
Capital expenditure (net) and financial investment	(153)	(293)
Dividends received from equity accounted investments	95	94
Assets contributed to Trust	–	(25)
<b>Operating business cash flow<sup>8</sup></b> <span style="background-color: #0056b3; color: white; padding: 0 2px;">KPI</span>	<b>147</b>	<b>2,692</b>
Interest	(166)	(147)
Taxation	(138)	(115)
<b>Free cash flow</b>	<b>(157)</b>	<b>2,430</b>
Acquisitions and disposals	4	96
Net purchase of own shares	(212)	(16)
Equity dividends paid	(638)	(620)
Dividends paid to non-controlling interests	(11)	(11)
Cash outflow from matured derivative financial instruments	(47)	(119)
Movement in cash collateral	(10)	(2)
Movement in cash received on customers' account <sup>10</sup>	1	1
Foreign exchange translation	3	92
Other non-cash movements	(19)	(25)
<b>Total cash (outflow)/inflow</b>	<b>(1,086)</b>	<b>1,826</b>
Opening net cash/(debt) (as defined by the Group) <sup>9</sup>	387	(1,439)
<b>Closing net (debt)/cash (as defined by the Group)<sup>9</sup></b>	<b>(699)</b>	<b>387</b>

## Movement in the Group's pension deficit (£bn)



➔ See note 23 to the Group accounts on page 162

## Balance sheet

The £1.2bn reduction in **intangible assets** to £9.7bn (2012 £10.9bn) mainly reflects the impairment of goodwill in the US business (£0.9bn) and amortisation (£0.2bn).

**Property, plant and equipment, and investment property** reduced to £2.1bn (2012 £2.4bn) mainly reflecting the classification of a residential and office facility in Saudi Arabia as held for sale at the balance sheet date. A sale and leaseback transaction for the facility was completed on 9 January 2014.

**Equity accounted investments and other investments** are £286m (2012 £270m). The Group's share of results of equity accounted investments (£111m) was largely offset by dividends received (£95m).

The £1.1bn decrease in the Group's share of the pre-tax **pension deficit** mainly reflects asset returns. The impact of a 0.5 percentage point reduction in the UK real discount rate to 1.1% was offset by the impact of the rate of increase in salaries being held at Retail Prices Index (RPI) inflation (2012 0.5% above RPI), a 0.8 percentage point increase in the US nominal discount rate to 4.9% and deficit funding. The movement in the pension deficit during the year is illustrated in the bridge chart above.

A net deferred tax asset of £0.7bn (2012 £1.1bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

There was a £1.6bn increase in **working capital** mainly reflecting a net reduction in advance contract funding and utilisation of provisions.

## Summary balance sheet

	2013 £m	2012 £m
Intangible assets	9,735	10,928
Property, plant and equipment, and investment property	2,071	2,407
Equity accounted investments and other investments	286	270
Other financial assets and liabilities (net)	(23)	(50)
Tax assets and liabilities (net)	405	951
Pension deficit	(3,509)	(4,560)
Working capital	(4,988)	(6,557)
Net (debt)/cash (as defined by the Group) <sup>9</sup>	(699)	387
Net assets/(liabilities) held for sale	140	(2)
<b>Net assets</b>	<b>3,418</b>	<b>3,774</b>

## Exchange rates – year end

	2013	2012
£/\$	1.656	1.624
£/€	1.202	1.232
£/A\$	1.851	1.564

## Capital

The Group's objective is to maintain its investment grade credit rating and ensure operating flexibility. In 2013, the Group's credit ratings were maintained at:

- Moody's Investors Service – Baa2;
- Standard & Poor's Ratings Services – BBB+; and
- Fitch's Investors Service – BBB+.

➔ See page 23

## Tax

The Group's tax strategy is to: ensure compliance with all applicable tax laws and regulations; and manage the Group's tax expense in a way that is consistent with its values and its legal obligations in all relevant jurisdictions.

➔ See page 120

## Treasury

The Group's treasury activities, including the use of financial instruments, are overseen by the Treasury Review Management Committee, which includes two executive directors and representatives with legal and tax expertise.

➔ See page 175

## Pensions

The Group's principal pension schemes are funded defined benefit schemes.

The two largest funded defined benefit schemes are the BAE Systems Pension Scheme and the BAE Systems 2000 Pension Plan.

➔ See page 162

7 2012 excludes the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net (debt)/cash.

8 See note 9 to the Group accounts.

9 See note 10 to the Group accounts.

10 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 consolidated balance sheet.

# SEGMENTAL PERFORMANCE

The Group has five principal reporting segments which align with the Group's strategic direction.

## Reporting segments financial performance summary

	KPI		KPI	KPI		KPI
	Funded order intake <sup>1</sup> £m	Order backlog <sup>1,2</sup> £bn	Sales <sup>1</sup> £m	Underlying EBITA <sup>3</sup> £m	Return on sales %	Cash flow <sup>4</sup> £m
2013						
Electronic Systems	2,697	3.7	2,466	346	14.0	235
Cyber & Intelligence	1,247	0.7	1,243	115	9.3	118
Platforms & Services (US)	3,421	7.4	4,196	265	6.3	192
Platforms & Services (UK)	5,979	20.3	6,890	879	12.8	59
Platforms & Services (International)	7,221	12.3	4,063	429	10.6	(189)
HQ	303	–	306	(109)		(268)
	20,868	44.4	19,164			
Less: Intra-group	(1,580)	(1.7)	(984)			
<b>Total</b>	<b>19,288</b>	<b>42.7</b>	<b>18,180</b>	<b>1,925</b>	<b>10.6</b>	<b>147</b>

1 Including share of equity accounted investments.

2 Comprises funded and unfunded unexecuted customer orders.

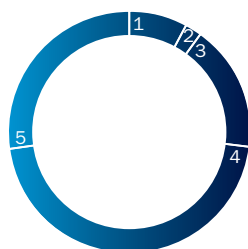
3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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

5 Excluding HQ.

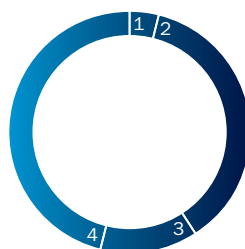
6 Including share of equity accounted investments' order backlog and before the elimination of intra-group order backlog.

7 The appropriate work share of the Saudi Aircraft Acquisition (under the Saudi British Defence Co-operation Programme), Saudi Typhoon Aircraft and Saudi Typhoon Support contracts is reported within Platforms & Services (UK).

Order backlog<sup>2,5,6</sup> by reporting segment (%)

1 Electronic Systems	8
2 Cyber & Intelligence	2
3 Platforms & Services (US)	17
4 Platforms & Services (UK)	46
5 Platforms & Services (International)	27

The Group has a £42.7bn order backlog<sup>1,2</sup>.

Top 15 programmes in order backlog<sup>2,5,6</sup> (%)

1 Platforms & Services (US)	4
2 Platforms & Services (UK)	37
3 Platforms & Services (International)	13
4 Remaining order backlog	46

54% of the order backlog<sup>2,5,6</sup> is represented by the Group's top 15 programmes, with the remaining 46% spread across the five principal reporting segments.

## Top 15 programmes in order backlog<sup>2,5,6</sup> summary

Platforms & Services (US)		
Programme	Description	End user
Munitions Acquisition Supply Solution	Capability provision and manufacture of general munitions	British Army
Paladin Integrated Management (PIM)	Low-Rate Initial Production of 18.5 vehicle sets, comprising 19 PIM howitzers and 18 PIM Carrier Ammunition Tracked vehicles	US Army
Norway CV90 Armoured Combat Vehicles	Supply of 144 new and 103 upgraded CV90 armoured combat vehicles	Norwegian Army
Platforms & Services (UK)		
Programme	Description	End user
Queen Elizabeth Class Aircraft Carriers	Design and manufacture of two 65,000 tonne aircraft carriers	Royal Navy
Astute Class Submarines	Design and manufacture of seven nuclear-powered attack submarines	Royal Navy
Successor Submarine	Design of nuclear-powered submarine to carry the UK's nuclear deterrent	Royal Navy
Typhoon Tranche 3A Aircraft	Manufacture of 88 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain
Typhoon Tranche 2 Aircraft	Manufacture of 236 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain
Oman Typhoon and Hawk Aircraft	Supply of 12 Typhoon and eight Hawk aircraft and in-service support	Royal Air Force of Oman
Availability Transformation Tornado Aircraft Contract (ATTAC)	Availability service for Tornado aircraft, including maintenance, support and training	Royal Air Force
Platforms & Services (International)		
Programme	Description	End user
Saudi British Defence Co-operation Programme <sup>7</sup>	Provision of support to operational capability, including the provision of training aircraft, manpower, logistics and training	Royal Saudi Air Force
Saudi Typhoon Aircraft <sup>7</sup>	Supply of 72 Typhoon combat aircraft	Royal Saudi Air Force
Saudi Typhoon Support <sup>7</sup>	Availability contract for Typhoon aircraft, including maintenance, support and training	Royal Saudi Air Force
Landing Helicopter Dock	Design, production and supply of two 27,000 tonne amphibious Landing Helicopter Dock ships	Royal Australian Navy
Aster Phase 3	Full-scale production of Aster 15 and 30 missiles	French, Italian and Royal navies, French Air Force and Italian Army

# ELECTRONIC SYSTEMS

Electronic Systems, with 12,500 employees<sup>1</sup>, comprises the US and UK-based electronics activities, including electronic warfare systems and electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.



## 2013 EXECUTIVE COMMITTEE OBJECTIVE

Be agile, sustain revenues and deliver strong bottom line performance

## KEY CHARACTERISTICS

- Broad base of programmes, with more than 5,000 active contracts
- No programme greater than 5% of sales
- Cutting-edge technology and capabilities, with significant levels of research and development invested in the business
- 21% of total sales are to commercial customers

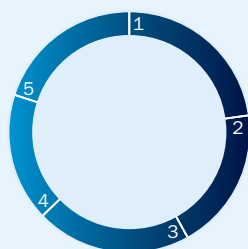


## Electronic Combat

Under Foreign Military Sale contracts totalling over \$0.9bn (£0.5bn), the Digital Electronic Warfare System (DEWS) will be installed on 84 new F-15 aircraft with upgrades to 70 existing F-15 aircraft for the Royal Saudi Air Force. The Group continues to pursue other export opportunities for the DEWS suite, which provides advanced radar warning and countermeasure capabilities, improved situational awareness, offensive targeting support and self-protection.

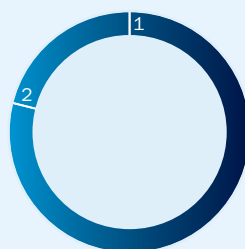


## Sales analysis: activity (%)



1 Electronic Combat	23
2 Survivability & Targeting	19
3 Communications & Control	21
4 Intelligence, Surveillance & Reconnaissance (ISR)	17
5 Commercial Aircraft electronics/HybriDrive® propulsion	20

## Sales analysis: defence and commercial (%)



1 Defence	79
2 Commercial	21

## Progress on sustainability

Recordable Accident Rate	21%	↑
Major injuries		↑
Energy		↓
Water		↓
Waste		↓

		2013	2012	2011
Funded order intake <sup>1</sup>	KPI	£2,697m	£2,540m	£2,620m
Order backlog <sup>1,4</sup>		£3.7bn	£3.6bn	£3.6bn
Sales <sup>1</sup>	KPI	£2,466m	£2,507m	£2,645m
Underlying EBITA <sup>2</sup>	KPI	£346m	£356m	£386m
Return on sales		14.0%	14.2%	14.6%
Cash inflow <sup>3</sup>	KPI	£235m	£256m	£268m

## FINANCIAL KEY POINTS

- 6% like-for-like increase in order backlog<sup>1,4</sup>
- Sales<sup>1</sup> reduced by 2%, with growth in the commercial business mitigating the defence decline
- Return on sales maintained at around 14%

## OPERATIONAL KEY POINTS

- Maintained a leadership position in the electronic warfare market, with strong performance on the Group's components for F-35 Lightning II
- Won a development contract on the US Army's Joint Effects Targeting System programme
- Strengthened position in the Identification Friend or Foe market
- Strengthened position in the high-growth commercial aircraft electronics market
- Not selected on the US Army's next-generation Mid-tier Networking Vehicular Radio programme
- £0.2bn of research and development expenditure<sup>5</sup> in 2013

## SUSTAINABILITY KEY POINTS

- Increase in Recordable Accident Rate primarily due to an increase in outside slips, trips or falls
- Reduced energy and water usage, and quantity of waste produced

1 Including share of equity accounted investments.

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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 Comprises funded and unfunded unexecuted customer orders.

5 Includes both Group-funded and customer-funded expenditure.



### Survivability & Targeting

BAE Systems was awarded a contract to support the US Army's Joint Effects Targeting System programme based on the HAMMER™ precision targeting system, which has been designed to enhance soldiers' ability to rapidly identify, precisely locate and accurately mark targets for Global Positioning System-guided and laser-guided munitions in all weather and lighting conditions.



### Financial performance

Despite US budget pressures, order backlog<sup>1,4</sup> of £3.7bn was up from the start of the year, benefiting from production awards on the Terminal High-Altitude Area Defence programme.

Sales<sup>1</sup> compared with 2012 decreased by 2% to £2,466m (2012 £2,507m). The commercial areas of the business amount to 21%, having seen sales growth in the year of 8%. This helped to offset some of the pressures on the defence side, which reduced by 5% in the year.

The return on sales achieved was 14.0% (2012 14.2%). Programme execution remained strong, with good risk retirement and in-year benefit from continued cost reduction actions.

Cash flow<sup>3</sup> conversion of underlying EBITA<sup>2</sup> for the year was 68%, but excluding pension deficit funding, that conversion rate was 89%.

### Operational performance

#### Electronic Combat

Electronic Systems maintains its leadership position in the US electronic warfare market. Under the flight test programme for the electronic warfare suite on the F-35 Lightning II programme, initial design verification testing of the system was completed. Low-Rate Initial Production (LRIP) Lot 6 deliveries continued throughout the year and initial Lot 7 deliveries commenced. The business was awarded a not-to-exceed contract of \$143m (£86m) for LRIP Lot 8.

Under contracts totalling over \$0.9bn (£0.5bn), the Digital Electronic Warfare System (DEWS) will be installed on 84 new F-15 aircraft with upgrades to 70 existing F-15 aircraft for the Royal Saudi Air Force. Initial flight testing began in November. The business continues to pursue other export opportunities for the DEWS suite.

The business was successful in demonstrating the Long-Range Anti-Ship Missile (LRASM) prototype in a direct-hit live missile shot test under a joint programme of the Defense Advanced Research Projects Agency and the Office of Naval Research. Offering capabilities not available in current cruise missile systems, LRASM is a next-generation, anti-ship missile for which the business provides a radio frequency sensor used for targeting. LRASM is being developed as an advanced prototype for rapid transition to the US Navy's Offensive Anti-Surface Weapon programme.

BAE Systems was not awarded the technology development contract for the Next-Generation Jammer.

#### Survivability & Targeting

Electronic Systems continues to execute its \$38m (£23m) technology development contract in a competition to provide the Common Infrared Countermeasures capability for the US Army, meeting or exceeding every programme milestone. The programme is now in a government-led test phase.

The Advanced Precision Kill Weapon System™ continues to demonstrate its versatility, completing qualification and successful testing on almost a dozen fixed and rotary wing platforms for the US armed forces. The business continues to execute its \$69m (£42m) Full-Rate Production contract. More than 2,000 systems have been delivered, with continued positive feedback from performance in theatre.

The Terminal High-Altitude Area Defence programme provides a transportable, rapidly deployable, ground-based capability to intercept and destroy ballistic missiles inside or outside the atmosphere during their final phase of flight. BAE Systems has received orders of \$340m (£205m) in combined US government and Foreign Military Sales to the United Arab Emirates.

BAE Systems was awarded a \$15m (£9m) contract to support the US Army's Joint Effects Targeting System programme in March with its HAMMER™ precision targeting system, which has been designed to enhance soldiers' ability to rapidly identify, precisely locate and accurately mark targets for Global Positioning System-guided and laser-guided munitions in all weather and lighting conditions. The contract initiates a three-year engineering and manufacturing development phase, and is a key win that advances BAE Systems' market leadership in precision targeting 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 page 33).

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 Comprises funded and unfunded unexecuted customer orders.

### Communications & Control

The business supplies Active Inceptors for the F-35 Lightning II which are the pilot interface in the cockpit, providing tactile feedback through the stick and throttle.



### Commercial Aircraft electronics

The business is well positioned, with robust growth forecast in commercial aviation and related products and services in an industry expected to grow by 5% annually over the next decade. Its position with Boeing was enhanced with wins on the 737 MAX and by joining the 'Partnering for Success' initiative that will re-inforce its standing as a preferred supplier to Boeing.

### Communications & Control

The F-35 Lightning II programme continues to be a key platform for the Group's avionics products with deliveries on plan for the active inceptor and vehicle management systems. The US Air Force has discontinued second sourcing efforts for the advanced helmet system that was being provided by BAE Systems.

BAE Systems was not selected on the US Army's next-generation Mid-tier Networking Vehicular Radio competition.

### Intelligence, Surveillance & Reconnaissance (ISR)

The business continues to provide Airborne Surveillance capability for the US Air Force and US Army. These key programmes are based on two wide-area, high-resolution imaging sensor systems, the Airborne Wide Area Persistent Surveillance System, which has been operational for more than 16,000 hours in theatre, and the Autonomous Real-time Ground Ubiquitous Surveillance – Imaging System.

The business is providing state-of-the-art processing capabilities to Boeing for the US Navy's P-8A Poseidon programme, which has entered Full-Rate Production. Sixteen production mission computer and display systems have been delivered to the US Navy. Eight systems have been delivered to the Indian Navy, the first international customer.

In the Identification Friend or Foe market, BAE Systems has been awarded a \$34m (£21m) contract to provide its enhanced Combined Interrogator Transponder system to the US Air Force and participating European air force partners. Deliveries of the Reduced Size Transponder have been completed for the US Navy's Triton System Design and Development programme and BAE Systems is now under contract for Low-Rate Initial Production.

In 2013, BAE Systems achieved a cumulative equivalent of 7,000 years in space across its three generations of space computers. The third-generation RAD750® computer has now been launched on more than 35 satellites supporting civil, national and commercial missions. The business is continuing to innovate in the space processing market with the development of its next-generation space computer.

The business continues to provide Signal Intelligence (SIGINT) capability for the US Army and Special Operations Command. These programmes are based on the Group's S-3000 family of SIGINT systems and have successfully deployed with multiple customers.

### Commercial Aircraft electronics

The business continues to expand its market opportunities for Full Authority Digital Engine Controls (FADEC). FADEC Alliance, a joint venture between FADEC International, the Group's joint venture with Sagem, and GE Aviation, delivered the Leap FADEC and successfully completed testing on GE's Passport 20 engine. Entry into service of the Passport engine, which will power Bombardier's Global 7000 and 8000 jets, is scheduled for 2016. The Leap FADEC will be used on the Boeing 737 MAX and Airbus A320neo.

Following successful first flights of Embraer's mid-size business jet, Legacy, and Bombardier's CRJ regional aircraft, enabled by several flight control subsystems provided by BAE Systems, efforts are now focused on both aircraft entering full revenue service.

**HybriDrive® propulsion**

BAE Systems has delivered 4,200 HybriDrive® propulsion systems since 2004 through six bus manufacturers, which are now in service with more than 80 operators.



BAE Systems is a supplier on the Boeing 737 MAX, notably with the fly-by-wire spoiler controls. Contracts awarded to the Group have a total potential value of \$1bn (£0.6bn) over the life of the aircraft programme.

The business has opened a new office in Shanghai which will enable it to expand its commercial aftermarket presence in China, whilst strengthening existing and developing new partnerships with in-country suppliers and airframe manufacturers.

**HybriDrive® propulsion**

Dijon, France, a new customer for the business, has taken delivery of 102 buses from Iveco powered by HybriDrive® propulsion systems, making it the largest hybrid fleet in mainland Europe. King County Metro, Seattle, Washington, purchased 120 New Flyer buses powered by HybriDrive® Series-E systems, the county's latest hybrid product, to add to its existing HybriDrive®-powered fleet.

**Sustainability performance****Safety**

The business experienced a 21% increase in the Recordable Accident Rate, which was driven largely by an increase in outside slips, trips or falls. Safety remains a key value and the business continues to maintain long-term injury rates better than benchmarked world-class companies. Updated ergonomics and injury/illness prevention plans were rolled out in 2013.

**Diversity and inclusion**

The business supported US-wide diversity and inclusion activities, including inclusive leadership training, the launch of employee resource groups, and introducing diverse candidate shortlists and interview panels for executive roles. Leadership involvement and multiple activities within the business have advanced the diversity maturity level in 2013.

**Environment**

BAE Systems, partnering with the City of Austin, Texas, installed a new water treatment process which uses water from a local waste water treatment plant to run the site's chilled water condenser systems, rather than potable water. The process is expected to save the business \$65,000 per year and reduce annual potable water consumption in the drought-ridden region by an estimated ten million gallons.

**Engagement**

In addition to its successful quarterly 'One Team Award' programme, Electronic Systems introduced a special employee recognition award this year, the 'PathFinder' award. The 'One Team Award' recognises teams for exemplifying one or more of five imperatives demonstrated through end-user impact: community focus; technology innovation; collaboration; best practices; and overall value to the business. The quarterly 'PathFinder' award recognises those teams or individuals whose innovative contributions helped to lead the way and grow the business.



For Group sustainability performance, see Sustainability section on pages 112 to 119

**Looking forward**

Efforts to reduce the US government's budget deficit are expected to continue to impact government spend. A bipartisan budget proposal was approved in December 2013 that mitigates the full impact of the Sequester for 2014 and 2015. The Group expects lower defence spending than previously programmed, but the cuts are not expected to be as significant or indiscriminate as they would have been under Sequestration.

Whilst further funding reductions and the resultant slow down or cancellation of ongoing and new programmes could impact the business, Electronic Systems continues to be well-positioned to address the changing US Department of Defense priorities with its balanced portfolio of programmes and customers, and its sustained emphasis on cost reduction and research and development.

The business expects to benefit from its incumbent positions and ability to provide capability upgrades on platforms. The business anticipates increased activity on international defence programmes and continued growth in the commercial aviation market.



# CYBER & INTELLIGENCE

Cyber & Intelligence, with 7,700 employees<sup>1</sup>, comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence (formerly BAE Systems Detica) business, and covers the Group's cyber, secure government, and commercial and financial security activities.

## 2013 EXECUTIVE COMMITTEE OBJECTIVE

Enhance and grow our positions in cyber, intelligence and security

### KEY CHARACTERISTICS

#### Intelligence & Security

- Delivers real-time threat assessments that rapidly inform critical security actions. The business is a leading provider of specialised security and intelligence operational support and solutions in the US
- Delivers automated, efficient and reliable intelligence processing, data management systems and imagery mapping tools for the US intelligence and defence communities
- Delivers cost-effective IT solutions that solve complex problems of collaboration and security for the US national security community

#### Applied Intelligence

- Delivers solutions which protect and enhance clients' operations across the areas of cyber security, financial crime, communications intelligence and digital transformation
- Portfolio of solutions which help governments and commercial enterprises to address threats to national security, detect sophisticated cyber attacks, counteract fraud, safeguard mobile communications, manage risk, ensure compliance and derive insight from data
- Provides managed services to help clients optimise and protect both mobile and fixed data networks

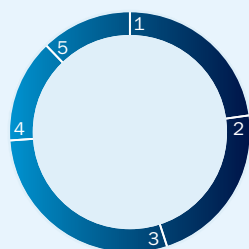


#### Applied Intelligence

Detica MobileProtect™ is a carrier-grade cloud-based service for enterprises and governments who need to secure smart devices. Using Applied Intelligence's unique global cleaning hubs, the service scans inbound and outbound traffic with minimal effect on network speed. It filters traffic, scans for malware and known security threats, and blocks inappropriate, insecure or illegal content.

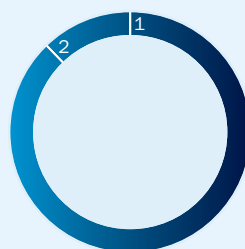
<sup>1</sup> Including share of equity accounted investments.

## Sales analysis: activity (%)



1 Global Analysis and Operations	23
2 GEOINT-ISR	22
3 IT Solutions	29
4 Applied Intelligence government	14
5 Applied Intelligence commercial	12

## Sales analysis: government and commercial (%)



1 Government	88
2 Commercial	12

## Progress on sustainability

Recordable Accident Rate	17%	↓
Major injuries		↑
Energy		↓
Water		↓
Waste		↓

		2013	2012	2011
Funded order intake <sup>1</sup>	KPI	£1,247m	£1,454m	£1,443m
Order backlog <sup>1,4</sup>		£0.7bn	£1.0bn	£1.1bn
Sales <sup>1</sup>	KPI	£1,243m	£1,402m	£1,399m
Underlying EBITA <sup>2</sup>	KPI	£115m	£124m	£136m
Return on sales		9.3%	8.8%	9.7%
Cash inflow <sup>3</sup>	KPI	£118m	£113m	£123m

## FINANCIAL KEY POINTS

- Order backlog<sup>1,4</sup> reduced by 24% reflecting delayed awards in the US business. Order backlog<sup>1</sup> in Applied Intelligence increased by 60%
- Sales<sup>1</sup> reduced by 11% reflecting an 18% decrease in Intelligence & Security and a 9% increase in Applied Intelligence
- Return on sales of 9.3% includes continued high levels of spend to support organic growth in Applied Intelligence

## OPERATIONAL KEY POINTS

## Intelligence &amp; Security

- Awarded a three-year follow-on contract to the Counter-Improvised Explosive Device programme
- Maintained a leadership position in activity-based intelligence
- Continued to invest in differentiating technologies to support a bid pipeline of \$2.4bn (£1.4bn) at the end of 2013
- US business significantly impacted by US budget pressures and partial government shutdown

## Applied Intelligence

- Named as cyber security partner to Vodafone for provision of secure mobile services
- Achieved launch of new product for detection of sophisticated cyber threats, CyberReveal™, adopted by one major investment bank
- A number of important customer wins for NetReveal® OnDemand services
- Awarded framework contracts for IT services to the Foreign & Commonwealth Office and Network Rail
- Awarded integrated cyber security services contracts to three Middle Eastern countries

## SUSTAINABILITY KEY POINTS

- Reduced Recordable Accident Rate by 17%
- Reduced energy and water usage, and quantity of waste produced

1 Including share of equity accounted investments.

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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 Comprises funded and unfunded unexecuted customer orders.





### Global Analysis and Operations

The business is executing the Combat Intelligence Augmentation Teams contract, a follow-on contract to the Counter-Improvised Explosive Device programme. The business provides almost 300 security-cleared intelligence analysts.

### GEOINT-ISR

In continuation of its leadership position in activity-based intelligence, in October, the business received authorisation to proceed on an Engineering Change Proposal that will include analytics automation for complex mission problems across the intelligence community.



### Financial performance

Order backlog<sup>1,4</sup> reduced to £0.7bn (2012 £1.0bn). The US business continued to be impacted by budget-induced delays to award decisions of competitive bids. At 31 December 2013, there were some \$2.4bn (£1.4bn) of competitive bids of which more than half were overdue against decision timescales. In addition, some \$320m (£193m) of backlog has been removed following customer de-scoping across a large number of programmes. By contrast, order backlog<sup>1</sup> in the Applied Intelligence business grew by 60%.

Sales<sup>1</sup> in the year reduced by 11% to £1,243m (2012 £1,402m). The US business saw an 18% decrease, including the reduction from the Counter-Improvised Explosive Device programme, and the impacts from budget reductions were experienced more quickly than expected, with competitive award decisions continuing to be delayed. Growth in the Applied Intelligence business was at 9%.

The return on sales achieved of 9.3% (2012 8.8%) includes the continued organic investment in the Applied Intelligence business in support of targeted future growth in commercial and international markets.

Cash flow<sup>3</sup> conversion of underlying EBITA<sup>2</sup> for the year was at 103%.

### Operational performance

#### Intelligence & Security

The US-based Intelligence & Security business delivers a broad range of solutions and services, including systems development, IT, cyber operations and intelligence analysis to enable the US military and government to recognise, manage and defeat threats. The business is structured into three key business areas that provide specific domain expertise, whilst working closely together to provide enterprise-wide support to a range of customers and key agencies in the intelligence, defence, homeland security and civilian markets.

The business has been impacted by uncertainty in future programme budget levels, driven first by Sequestration and then by the partial US government shutdown in October, which had greater impacts on services and support programmes. Some customers have chosen to reduce contractor volumes significantly on existing programmes, delay award activity on pending programmes or simply cancel others. The level of impact has been much higher than anticipated.

**Global Analysis and Operations** provides mission-enabled analytic solutions and support to operations across the US homeland security, law enforcement, defence, intelligence and counter-intelligence communities.

The business won all task orders competed in the market for Full Motion Video Analysis during the year and continues to execute awarded contracts, which are worth over \$400m (£242m), with over 300 analysts supporting mission critical activities.

In August, the \$450m (£272m) Counter-Improvised Explosive Device programme ended and the follow-on programme, Combat Intelligence Augmentation Teams, began. Orders on the new programme totalling approximately \$150m (£91m) are expected over the next three years. The business continues to provide almost 300 security-cleared intelligence analysts working alongside forward deployed US defence personnel in Afghanistan.

#### **GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance)**

develops and supports software systems and mission applications for geospatial tasking, including data collection, processing, exploitation and dissemination, as well as mission planning, Intelligence, Surveillance and Reconnaissance (ISR), precision targeting, and command and control for the US defence and intelligence communities.

In October, the business received authorisation to proceed on a \$16m (£10m) M151 Engineering Change Proposal (ECP) that continues its leadership in activity-based intelligence. The scope of the ECP includes analytics automation for complex mission problems across the intelligence community.

In September, the business was awarded the first ECP on the Mobility Air Force Automated Flight Planning Service programme to develop and sustain a new air vehicle flight planning and route optimisation capability for the US Air Force's Tanker Airlift Control Center under the \$62m (£37m) contract awarded in April. The ECP focuses on the Aero Advisory Notification Tool capability in support of the Air Force's transition to a consolidated mission planning architecture.



### IT Solutions

Based on strong performance providing virtual desktop infrastructure and secure access capabilities, work increased on the Next-Generation Desktop Environment programme for the US Defense Intelligence Agency by providing global networking solutions in US Korea Command and US Africa Command.



**IT Solutions** develops, deploys and maintains mission applications focused on information sharing, knowledge management and enhanced enterprise mission IT solutions for the US federal, civilian and defence intelligence communities. The business also provides analytics, cyber analysis and real-time network forensics.

Work increased on the \$70m (£42m) Next-Generation Desktop Environment programme for the US Defense Intelligence Agency by providing global networking solutions in US Korea Command and US Africa Command, based on virtual desktop infrastructure and multiple-security-level access.

On the Solutions for the Information Technology Enterprise Indefinite Delivery, Indefinite Quantity contract, with task orders worth \$344m (£208m), the business has transitioned the customer from a costly regional support model to an efficient enterprise support model. Through the implementation of the Global Enterprise Operation Center, the business has enabled the US Defense Intelligence Agency to provide reliable, cost-effective and highly secure IT services to over 50,000 Department of Defense personnel worldwide with no impact to mission.

Under the \$0.5bn (£0.3bn) Centralized Operations, Maintenance and Management Information Technology Indefinite Delivery, Indefinite Quantity contract, the business won a task order to provide 24/7 monitoring support for the Federal Emergency Management Agency Security Operations Center. The award brings total task orders under the contract to over \$110m (£66m) and maintains BAE Systems' position as the largest provider of IT services on the contract.

In January 2013, the business was awarded a \$127m (£77m) contract to support the US National Security Agency's High Performance Computing Infrastructure Group with architecture, installation and administration for a complex networking environment supporting multiple network enclaves and high-speed data centre access. Under the contract, both server and desktop computer support will be provided to more than 3,000 end users.

#### **Applied Intelligence (formerly BAE Systems Detica)**

The business continues to grow through selling its portfolio of products and services to domestic and international governments, financial institutions, communications service providers, energy and utility operators and other commercial enterprises.

The business is demonstrating its ability to win large, multi-year contracts. It has extended its portfolio of products and services, and is responding to demand for solutions which combine capabilities from across its portfolio, where client requirements are converging. Market awareness and recognition continue to grow, evidenced through a number of industry analyst and association awards during the year. The business has opened a Global Delivery Centre in Malaysia to augment capability alongside existing centres in the UK and Poland.

#### **Cyber Security**

New additions to the product portfolio in 2013 have included: CyberReveal™, an advanced cyber threat monitoring solution, already sold to a major global financial institution; MobileProtect™, a cloud-based service for securing smart mobile devices, launched alongside a five-year strategic partnership with Vodafone; and IndustrialProtect™, a military-grade solution to protect organisations' industrial control systems. MobileProtect™ subscribers are expected to exceed 100,000 during 2014.

Managed security services continue to gain traction, with the business named as official cyber security partner to McLaren in April. In December, the business won new cyber security and services contracts totalling £48m in the Middle East.

#### **Financial Crime**

The business continues to provide enterprise risk, fraud and compliance solutions internationally.

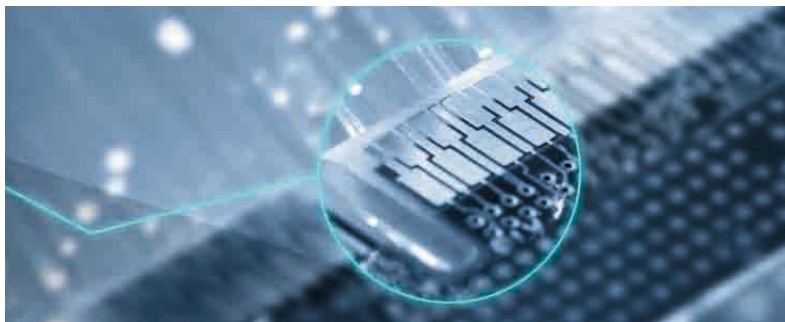
NetReveal® has been selected by CANATICS (Canadian National Insurance Crime Services) to provide a five-year managed analytics service to detect auto insurance claims fraud. It has been selected as preferred vendor by an Eastern European government to detect tax fraud and non-compliance, and has been selected by HMRC to extend its risk and fraud system to cover VAT repayment transactional fraud. The business has also broadened its offering to tackle emerging risks, such as unauthorised trading, including a significant sale to the investment banking division of a major global banking group. Other customer wins during the year include Commerzbank and Home Trust, contributing to a total order intake of £102m.

#### **Communications Solutions**

The business is a provider of end-to-end communications intelligence solutions internationally. It is addressing changes in market conditions which presented operational challenges in 2013. However, in 2014, it is pursuing opportunities in the Middle East and Asia Pacific regions and, in late 2013, won strategically important deals with both governments and communications service providers in Europe and North America.

### Applied Intelligence – IndustrialProtect™

Applied Intelligence has launched IndustrialProtect™ to the market. The military-grade solution is designed to protect the industrial control systems of organisations, such as power plants, oil refineries or automated manufacturing plants, from cyber attack, allowing them to modernise their legacy systems as well as improving their security.



### UK Services

The consulting, systems integration and managed services business had a successful year. It signed a framework contract with the Foreign & Commonwealth Office (FCO) to deliver service management integration services across the FCO's global IT estate, worth around £40m over a five-year period. The business also signed a framework agreement with Network Rail to provide IT solutions and systems integration over a four-year period.

The business continues to expand its relationships with communications service providers, including Vodafone and EE, providing solutions from across its portfolio.

### Sustainability performance

#### Safety

The Intelligence & Security business experienced a decrease in its injury rates as a result of direct leadership engagement and active employee involvement.

#### Diversity and inclusion

Applied Intelligence has increasingly focused on diversity and inclusion to understand, and raise awareness of, the merits of a genuinely diverse team and inclusive working environment. One example is the introduction of diverse panels for employment interviews.

#### Environment

Intelligence & Security has four LEED (Leadership in Energy and Environmental Design – US Green Building Council) sites and has implemented water reduction measures at three facilities. The business also removed hundreds of desktop printers across its US locations to reduce costs related to paper, ink and maintenance.

#### Engagement

Intelligence & Security launched an internal skills and training programme for employees. The business benefits from this investment by ensuring employees have the skills necessary to solve customers' toughest challenges. Around 70 different courses were offered in 2013 with nearly 2,000 employees completing over 22,000 hours of training.

Applied Intelligence conducted an awareness campaign in September focused on improving understanding about health issues faced by individuals within the business, including stroke, muscular dystrophy, diabetes and cystic fibrosis.



For Group sustainability performance, see Sustainability section on pages 112 to 119

### Looking forward

Efforts to reduce the US government's budget deficit are expected to continue to impact government spend. A bipartisan budget proposal was approved in December 2013 that mitigates the full impact of the Sequester for 2014 and 2015. The Group expects lower defence spending than previously programmed, but the cuts are not expected to be as significant or indiscriminate as they would have been under Sequestration.

The US market continues to experience delays in procurement awards. Customers will continue to look for opportunities to achieve efficiencies in IT services through consolidation and cloud computing, areas in which the US business has deep domain expertise and experience. Big data continues to pose a challenge for the US government and commercial businesses, which also provides an opportunity for growth.

Intelligence & Security is well-positioned to pursue opportunities in cyber, special operations and Intelligence, Surveillance and Reconnaissance, which remain priority activities in the US. Other avenues for growth exist across the intelligence analysis spectrum. The US business is also exploring international opportunities where its IT, cyber and analysis capabilities can be implemented by governments or in commercial markets.

Applied Intelligence expects continued growth both in the UK and internationally, with increasing demand from government and commercial sector customers for products and services which protect and enhance operations in the areas of cyber security, financial crime, communications intelligence and digital transformation.



# PLATFORMS & SERVICES (US)

Platforms & Services (US), with 19,200 employees<sup>1</sup>, comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, and the US-based services and sustainment activities, including ship repair and munitions services.



## 2013 EXECUTIVE COMMITTEE OBJECTIVE

Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector

### KEY CHARACTERISTICS

#### Land & Armaments

- Tracked combat vehicles
- Artillery and naval weapons
- Ammunition and new directed weapon technologies
- Support and sustainment of original equipment manufacturer platforms

#### Support Solutions

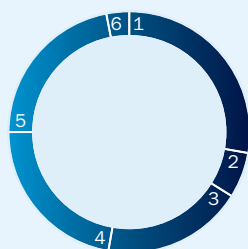
- US naval ship repair and modernisation
- Complex infrastructure services and operations support
- Aircraft sustainment and modernisation
- Commercial shipbuilding
- Soldier survivability products



### Infrastructure services

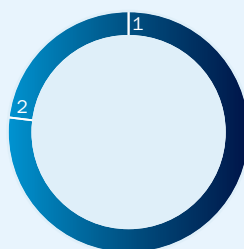
The Group continues as an industry leader in managing government-owned and contractor-operated munitions sites for the US military. BAE Systems has been the operating contractor of the Holston Army Ammunition Plant since 1999, developing innovative products, such as IMX-101, which the US Army approved as the first safe and effective replacement to TNT in artillery.

## Sales analysis: activity (%)



1 Tracked combat vehicles	28
2 Tactical wheeled vehicles	6
3 Artillery/munitions	19
4 Ship repair	22
5 Other support services	22
6 Protection Systems	3

## Sales analysis: platforms and services (%)



1 Military & Technical Services	77
2 Platforms	23

## Progress on sustainability

Recordable Accident Rate	3% ↓
Major injuries	↑
Energy	↓
Water	↓
Waste	↓

		2013	2012	2011
Funded order intake <sup>1</sup>	KPI	£3,421m	£5,010m	£5,077m
Order backlog <sup>1,4</sup>		£7.4bn	£8.4bn	£8.7bn
Sales <sup>1</sup>	KPI	£4,196m	£4,539m	£5,305m
Underlying EBITA <sup>2</sup>	KPI	£265m	£394m	£478m
Return on sales		6.3%	8.7%	9.0%
Cash inflow <sup>3</sup>	KPI	£192m	£314m	£410m

## FINANCIAL KEY POINTS

- Sales<sup>1</sup> reduced by 17% in Land & Armaments and increased by 2% in Support Solutions
- Return on sales increased to 9.3% in Land & Armaments and reduced to 3.0% in Support Solutions

## OPERATIONAL KEY POINTS

## Land &amp; Armaments

- Strong operational performance
- Continued focus on cost reduction actions
- Contract for Low-Rate Initial Production received on the Paladin Integrated Management programme
- Integration work ceased on Caiman Multi-Terrain Vehicles and Sealy, Texas, facility to close in 2014

## Support Solutions

- Performance impacted by charges taken on the Radford Army Ammunition Plant contract, commercial shipbuilding activity and not being awarded follow-on options on the US Navy aircraft maintenance contract
- Follow-on awards on US munitions facilities management contracts
- Significant multi-year contracts to support ballistic missiles in the US
- Letter of Agreement finalised for upgrades and systems integration for South Korean F-16 aircraft

## SUSTAINABILITY KEY POINTS

- Reduced Recordable Accident Rate by 3%
- Reduced energy and water usage, and quantity of waste produced

<sup>1</sup> Including share of equity accounted investments.

<sup>2</sup> Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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

<sup>4</sup> Comprises funded and unfunded unexecuted customer orders.



## US Combat Vehicles

In October, the business was awarded a contract for the Low-Rate Initial Production of the Paladin Integrated Management (PIM) 155mm self-propelled howitzer system. The PIM is a significant upgrade of the M109A6 Paladin self-propelled howitzer, restoring space, weight, power and cooling, whilst providing growth potential for emerging technologies.



## Weapon Systems

BAE Systems was awarded a contract to develop the Electromagnetic Railgun, which is a revolutionary, long-range weapon technology that uses high-power electromagnetic energy instead of explosive chemical propellants to launch hypervelocity projectiles.

## Financial performance

Order backlog<sup>1,4</sup> was £7.4bn (2012 £8.4bn). At Land & Armaments, order backlog<sup>1,4</sup> reduced to £4.3bn (2012 £5.1bn) reflecting trading on M777 and long-term UK munitions contracts. Disappointingly, the CV90 prospect in Canada was cancelled by the customer and no procurement decision has yet been taken by the Indian authorities with regard to the M777 lightweight howitzer acquisition. At Support Solutions, order backlog<sup>1,4</sup> reduced to £3.1bn (2012 £3.3bn) as the five-year ship repair Multi-Ship, Multi-Option contracts are traded through.

In aggregate, sales<sup>1</sup> were £4.2bn (2012 £4.5bn), representing a like-for-like reduction of 5%. At Land & Armaments, sales<sup>1</sup> declined by 10% on a like-for-like basis, taking into account exchange translation, the impact of last year's business disposals and the transfer of the Combat Vehicles (UK) business to Platforms & Services (UK). The sales<sup>1</sup> reduction was largely from completion of contracts for Mine Resistant Ambush Protected vehicle upgrades and lower Bradley reset work. In the Support Solutions business, sales<sup>1</sup> were 2% higher than in 2012. The business benefited from higher volumes in the ship repair and munitions facilities management businesses.

Underlying EBITA<sup>2</sup> was £265m (2012 £394m). Return on sales reduced to 6.3% (2012 8.7%). Return on sales at Land & Armaments of 9.3% (2012 8.6%) benefited from ongoing cost reduction actions and good programme execution, and includes the charge taken for the closure of the wheeled vehicle facility at Sealy. Return on sales at Support Solutions of 3.0% (2012 8.8%) includes a charge of \$46m (£29m) taken against overhead under-absorption relating to 2013 and future years as the business seeks to restructure the Radford Army Ammunition Plant contract.

In addition, a charge of \$30m (£19m) has been taken against cost overruns on commercial shipbuild activity.

Operating cash flow<sup>3</sup> reduced to £192m (2012 £314m). Cash flow<sup>3</sup> conversion of underlying EBITA<sup>2</sup>, excluding pension deficit funding, was 86% and 68% at Land & Armaments and Support Solutions, respectively. Operating cash flow<sup>3</sup> in Support Solutions was impacted by short-term US government payment delays.

## Operational performance

### Land & Armaments

#### US Combat Vehicles

Despite significant down-sizing and ongoing uncertainties in the US market, the business has continued to maintain key industrial base capabilities based on the US Army's stated requirements at the Bradley production line in York, Pennsylvania. In addition to domestic Bradley reset and conversion programmes, the business continues to make progress in securing international business, primarily in the Middle East. In November, Land & Armaments signed a joint venture agreement to pursue Bradley opportunities in Saudi Arabia.

Although uncertainty remains with respect to the future of the US Army's Ground Combat Vehicle programme, the business continues to support the US Army and execute its technology maturation and risk reduction contract. The Hybrid Electric Drive system successfully completed 2,000 miles of testing four months ahead of schedule.

In October, the Paladin Integrated Management (PIM) programme received a \$195m (£118m) contract to begin Low-Rate Initial Production. During this phase, BAE Systems will produce 18.5 vehicle sets, comprising 19 PIM howitzers and 18 PIM Carrier Ammunition Tracked vehicles.

Through future options, the US Army intends to purchase a total of 66.5 vehicle sets, plus spares, kits and technical documentation for a total contract value of \$688m (£416m).

During 2013, Land & Armaments continued to streamline its US business. The sale of the Commercial Armored Vehicles business completed in February and the Fayette, Pennsylvania, facility closed in December.

Whilst Land & Armaments remains a committed member of the Lockheed Martin Joint Light Tactical Vehicle (JLTV) programme, in August, the business received a notice of termination for convenience from the US government, ceasing all integration work on Caiman Multi-Terrain Vehicles. Following this notice, the business announced closure of the Sealy, Texas, facility by the end of June 2014. Work under the JLTV programme is in the process of transitioning to the York, Pennsylvania, facility.

### Weapon Systems

The business was awarded a \$40m (£24m) contract to produce vertical launching system canisters for the US Navy. If all options under the contract are exercised, the total value could exceed \$400m (£242m).

The business secured a \$57m (£34m) contract with the Royal Malaysian Navy for six naval guns that will equip the country's second-generation patrol vessels, Littoral Combat Ships.

The first five pre-serial Archer artillery systems were delivered to the Swedish Defence Materiel Administration (FMV). In December, Norway announced its intent to end its co-operation with Sweden on the Archer system. BAE Systems remains committed to the programme and continues to work with its customer, the FMV, to deliver the system to the Swedish armed forces.

1 Including share of equity accounted investments.

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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 Comprises funded and unfunded unexecuted customer orders.



### BAE Systems Hägglunds

BAE Systems Hägglunds is to supply an additional 102 BvS10 armoured all-terrain vehicles to the Swedish Ministry of Defence. This award follows the 2012 contract for delivery of 48 BvS10 vehicles. Multiple variants, including troop carrier, command vehicle, ambulance and logistic carrier vehicle, will be used by the Swedish Army.

### Ship repair and commercial shipbuilding

The US-based ship repair business continues to serve the US Navy as a leading provider of non-nuclear ship repair, maintenance and modernisation services. Concurrently, the business continues to grow its commercial shipbuilding operations, with a diverse US customer base including offshore energy support vessels, oil exploration and transport vessels, cargo ships, vessels supporting dredging operations, cruise ships and international carriers.



### BAE Systems Hägglunds

The business continues to have success with its CV90 programme. Work on the \$750m (£453m) contract for the Norwegian Army remains on schedule, with delivery of pre-series vehicles in February 2013 and series manufacture starting in September. A CV90 vehicle was delivered to the Danish Army to participate in a competitive evaluation to meet the requirement for future armoured personnel vehicles. The business signed a teaming agreement in May with Polish Defence Holdings to offer a new family of armoured vehicles based on CV90 technology.

In December, the business was notified of the Canadian government's decision to cancel its proposed Close Combat Vehicle programme.

In December, the Swedish government exercised its option to buy 102 more BvS10 all-terrain vehicles in an order worth approximately \$120m (£72m). This order follows its January 2012 purchase of 48 BvS10 vehicles that are under delivery to the Swedish Army.

### FNSS

FNSS, BAE Systems' Turkish joint venture, continues to produce and upgrade tracked and wheeled military vehicles for international customers.

Production has commenced under the \$559m (£338m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army and the first vehicles were delivered in 2013.

In December, FNSS received a \$360m (£217m) contract from the land forces of a Middle Eastern country for the upgrade of M113 tracked armoured personnel carriers. The business is pursuing other armoured vehicle prospects elsewhere in the region.

### Munitions

A pricing proposal for the next five years (2018 to 2022) of the Munitions Acquisition Supply Solution partnering agreement was submitted to the UK Ministry of Defence in September. Orders totalling £105m were received from the UK Ministry of Defence, US Navy, Kingdom of Saudi Arabia government and the French Ministry of Defence in the year.

The Munitions business will be reported in the financial results of the Platforms & Services (UK) reporting segment from 1 January 2014.

### Support Solutions

Whilst strategic contracts were won during the period, the US-based services businesses were impacted materially by budget uncertainties and operational challenges. There were operational challenges in commercial shipbuilding and on start-up activity on the Radford Army Ammunition Plant contract. In addition, the business was not awarded follow-on options under the US Navy training aircraft maintenance and logistics support contract, under which work continued until 1 December.

The conditional Worker Adjustment and Retraining Notification (WARN) Act notices issued in February to nearly 3,600 ship repair employees were largely mitigated by the funding legislation passed in March.

The US-based ship repair business achieved its commitments under Multi-Ship, Multi-Option contract vehicles with the US Navy, receiving orders totalling \$1.2bn (£0.7bn) for the repair, maintenance and modernisation of various vessels during the year.

BAE Systems continues to co-operate with ongoing government investigations regarding the employee fatality at the Mobile, Alabama, shipyard that occurred on 4 April when the Carnival Triumph cruise ship came free from its moorings during unexpected severe weather.

The business continues to manage the operations of the Holston Army Ammunition Plant in the US. In March, the US Army awarded an Indefinite Delivery, Indefinite Quantity contract valued at up to \$780m (£471m) over five years to operate and manage the Holston Army Ammunition Plant, as well as purchase explosives from the plant.

South Korea down-selected BAE Systems to upgrade avionics and electronic systems, as well as perform systems integration for its fleet of more than 130 F-16 aircraft. The US Congressional Notification process was completed with the Letter of Acceptance put in place in December.

In August, BAE Systems was awarded an eight-year, \$534m (£323m) contract from the US Air Force to maintain the readiness of Minuteman III intercontinental ballistic missiles in the US. The Group will provide systems engineering, integration, testing, logistics and other services to support the missile, ground and launch systems for 450 deployed missiles. In December, the US Navy awarded BAE Systems a three-year, \$171m (£103m) contract to continue providing engineering and integration support to Trident II D-5 submarine-launched ballistic missiles.

The US Army awarded Support Systems Associates, Inc., with BAE Systems as a subcontractor, the Logistics Support Facilities Management Activity contract to provide flexible, timely and cost-effective facilities, personnel and expertise to support aircraft modifications and other support services.

In protection systems, BAE Systems produced its one millionth combat helmet since the 1980s. A \$28m (£17m) order from the US Marine Corps for the production of lightweight combat helmets was received in February 2013.

In October, the business was awarded a \$60m (£36m) order from the US Defense Logistics Agency to produce additional tactical vests equipped with body armour and incorporating a number of benefits for the soldier, including a 10% weight reduction in the armour system.

In the maritime defence solutions business, BAE Systems was awarded an \$80m (£48m) contract to continue providing systems engineering and other technical services to support the operational readiness of US Navy submarine torpedoes and other weapons systems.

Under the Concepts and Operations for Space and Missile Defence Integration Capabilities contract, the business was awarded an \$85m (£51m), two-year extension to continue its support of the US Army in providing services for developing and understanding missile defence methods and technologies.

## Sustainability performance

### Safety

In April, Support Solutions held its first Safety Stand Down, engaging more than 12,000 employees across the business in interactive discussions regarding workplace safety. The employee response was positive, with more than 200 suggestions for improvement implemented across the organisation. The success of these activities is reflected in a 7% reduction in the Recordable Accident Rate.

### Diversity and inclusion

Land & Armaments has made progress in bringing diversity and inclusion awareness to its employees. The Diversity & Inclusion Council, Multi-Cultural Network, Women's Leadership Network and the formation of numerous Employee Resource Groups have fostered awareness, respect and inclusion across the organisation. In addition to the annual Diversity & Inclusion Conference, these groups hosted many open forums, conferences and workshops that provided a deeper understanding about the diversity that exists in the workforce.

### Environment

The ship repair business in Norfolk, Virginia, has been certified by the Virginia Department of Environmental Quality as an 'Extraordinary Environmental Enterprise' for its leadership and commitment to environmental stewardship.

### Engagement

Land & Armaments' leadership has put significant emphasis on retaining and attracting key talent within the organisation, as well as communicating more frequently and in more transparent ways with employees. In 2013, the president of the business instituted a bi-annual 'State of the Sector' address. Participation in the employee engagement survey of 76% represented an increase from 58% in 2012.



For Group sustainability performance, see Sustainability section on pages 112 to 119

## Looking forward

Efforts to reduce the US government's budget deficit are expected to continue to impact government spend. A bipartisan budget proposal was approved in December 2013 that mitigates the full impact of the Sequester for 2014 and 2015. The Group expects lower defence spending than previously programmed, but the cuts are not expected to be as significant or indiscriminate as they would have been under Sequestration.

In the near term, Land & Armaments continues to operate in a challenging environment. To remain viable in the future, the business is investing to protect franchise programmes, including Bradley modernisation and the CV90 family, and establish new franchise programmes, such as Paladin Integrated Management. In addition, the business continues to offer export products to international markets and invest in new technology fast lanes, such as directed energy weapons and hybrid electric drives for combat vehicles. The business continues to drive rationalisation efforts to maximise efficiency and remain competitive.

Whilst potential cancellations and delays in new programmes could affect the business, Support Solutions may be able to offset the impact through additional opportunities to sustain and modernise existing platforms.



# PLATFORMS & SERVICES (UK)

Platforms & Services (UK), with 28,300 employees<sup>1</sup>, comprises the Group's UK-based air, maritime, combat vehicle, munitions and certain shared services activities.

## 2013 EXECUTIVE COMMITTEE OBJECTIVE

Deliver sustainably profitable through-life businesses in the air, maritime and combat vehicles sectors

### KEY CHARACTERISTICS

#### Military Air & Information

- Multi-year through-life programmes
- Military aircraft capabilities include design, development, manufacture, in-service support and training for combat and trainer aircraft, and design and development of Unmanned Air Systems
- Defence information systems, such as the Falcon secure deployable communication system
- Managed solutions for aircraft support services and engineering

#### Maritime

- Maritime capabilities include design, build, integration and commissioning, in-service support and training for naval ships, submarines, radar and combat management systems, and underwater systems

#### Combat Vehicles (UK)

- Design, build, demonstration and through-life support of armoured vehicles

#### Munitions

- Design, test, qualification, production, supply and through-life support of general munitions and the cased telescopic ammunition system

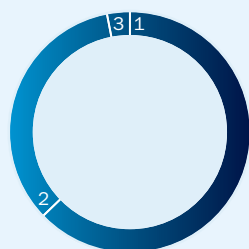
## ⬆ Maritime

The third of seven Astute Class submarines, *Artful*, a 7,400 tonne, 97-metre long, nuclear-powered attack submarine, was officially named in September and is expected to be launched in early 2014 for further tests and commissioning. The programme supports thousands of small and medium-size enterprises in the supply chain.

<sup>1</sup> Including share of equity accounted investments.

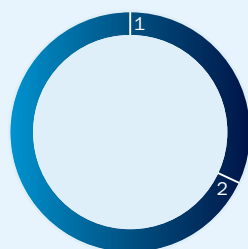


## Sales analysis: activity (%)



1 Military Air & Information	63
2 Maritime	34
3 Combat Vehicles (UK)	3

## Sales analysis: platforms and services (%)



1 Military & Technical Services	32
2 Platforms	68

## Progress on sustainability

Recordable Accident Rate **43%** ↓

Major injuries ↑

Energy ↓

Water ↓

Waste ↓

		2013	2012 <sup>1</sup>	2011
Funded order intake <sup>2</sup>	KPI	£5,979m	£8,160m	£4,355m
Order backlog <sup>2</sup>		£20.3bn	£21.3bn	£18.7bn
Sales <sup>2</sup>	KPI	£6,890m	£5,717m	£6,258m
Underlying EBITA <sup>3</sup>	KPI	£879m	£695m	£658m
Return on sales		12.8%	12.2%	10.5%
Cash inflow <sup>4</sup>	KPI	£59m	£1,717m	£69m

## FINANCIAL KEY POINTS

- Sales<sup>2</sup> increased by 21% on resumption of Salam Typhoon aircraft deliveries and trading of price escalation
- Return on sales of 12.8% benefited from the trading of price escalation and strong programme execution
- Operating cash flow<sup>4</sup> reflects the utilisation of advances and provisions

## OPERATIONAL KEY POINTS

- 34 Typhoon Tranche 2 and the first Tranche 3 aircraft delivered to the European partner nations
- First Hawk jets delivered to the Indian Navy
- Naval sector restructuring agreement reached with the UK Ministry of Defence
- Two Khareef Class corvettes for the Royal Navy of Oman achieved interim acceptance
- Sixth and final Type 45 destroyer accepted off-contract
- Third and final Offshore Patrol Vessel delivered to the Brazilian Navy
- £0.1bn of funding for ongoing design and development of the Royal Navy's Successor submarine
- Increased funding for the fifth, sixth and seventh Astute Class submarines

## SUSTAINABILITY KEY POINTS

- Reduced Recordable Accident Rate by 43%
- Reduced energy and water usage, and quantity of waste produced

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7 to the Group accounts).

2 Including share of equity accounted investments.

3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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

### Military Air & Information

Work is progressing on the contract received from the Sultanate of Oman to purchase 12 Typhoon and eight Hawk trainer aircraft at the end of 2012. As well as supplying aircraft, BAE Systems will provide in-service support to the Royal Air Force of Oman's operational activities.



### Financial performance

Order backlog<sup>2</sup> reduced to £20.3bn (2012 £21.3bn) on trading of aircraft deliveries under the contracts for European and Saudi Typhoon aircraft and the Indian Hawk contract.

The year's sales<sup>2</sup> of £6.9bn (2012 £5.7bn) were 21% higher than 2012, benefiting from the ten aircraft deliveries made on the Salam Typhoon programme and trading of the price escalation. There were no Salam aircraft deliveries made in 2012.

The return on sales of 12.8% (2012 12.2%) was strong, benefiting from not only the trading of the Salam Typhoon price escalation, but also another year of strong programme execution and risk reduction across the business.

There was a cash inflow<sup>4</sup> of £59m (2012 £1,717m) in the year reflecting the consumption of customer advances on the Omani Typhoon and Hawk programme, the European Typhoon contract and the Saudi training aircraft contract. In addition, provisions were utilised against costs incurred on rationalisation, on the Oman Offshore Patrol Vessel programme and for the Trinidad and Tobago termination settlement payment.

### Operational performance

#### Military Air & Information

In the year, deliveries of Typhoon Tranche 2 aircraft to the four partner nations totalled 34, bringing the total number of Tranche 2 aircraft delivered to 203 of the contracted 236. Sixteen Tranche 3 front fuselage sub-assemblies were manufactured in the year and the first Tranche 3 aircraft was delivered to the Royal Air Force (RAF).

Initial mobilisation under the Omani Typhoon and Hawk aircraft contract, awarded in December 2012, has commenced with the first aircraft deliveries scheduled for 2017.

The business continues to support its UK and European customers' Typhoon and Tornado aircraft and their operational commitments. The business supports its UK customer through availability-based service contracts.

On the F-35 Lightning II programme, the business has continued to deliver aircraft fuselages for the sixth Low-Rate Initial Production (LRIP) contract, delivering 26 aircraft sets to Lockheed Martin in 2013. Production for the seventh LRIP contract has commenced. A bid proposal for LRIP 8 has been submitted and negotiations have commenced.

Support continues to be provided to users of Hawk trainer aircraft around the world. The Indian Navy has received its first five Hawk aircraft from Hindustan Aeronautics Limited, built under the Batch 2 licence for 57 aircraft. Commercial discussions continue on the proposal for an additional 20 Hawk aircraft.

A response to the competitive proposal to supply eight Hawk trainer aircraft, support and training to Poland was submitted in November. Following evaluation by the Polish Ministry of Defence, the Group has been informed that it will not be down-selected for the next phase of this competition.

Working with UK industry partners and the Ministry of Defence, BAE Systems has designed and built a stealthy unmanned combat air vehicle demonstrator named Taranis. The aircraft made its maiden flight in August 2013 and has undertaken a number of successful trial flights.

Progress continued, to plan, on the joint BAE Systems and Dassault Aviation Future Combat Air System demonstration programme preparation contract to mature and demonstrate critical technology and operational aspects for an Unmanned Combat Air System.

In January 2014, it was announced that there would be further joint UK/French Future Combat Air System technology development under a two-year feasibility study worth £120m.

In the defence information domain, final deliveries of the Falcon secure deployable communication system for the British Army and RAF were completed in 2013, and the business continues to provide support for the system.

In the Regional Aircraft business, engineering revenues have remained under pressure reflecting the current trading conditions. This has been offset by a good performance within the support business.

## Maritime

In November, the Ministry of Defence announced that it planned to acquire three Offshore Patrol Vessels (OPVs) for the Royal Navy based on the Amazonas Class OPVs delivered to Brazil. The ships will sustain key shipbuilding skills in the UK's warship-building industry.



## Maritime

Following detailed discussions about how best to sustain the long-term capability to deliver complex warships, BAE Systems has proposed and agreed with the UK Ministry of Defence that Glasgow would be the most effective location for the manufacture of the future Type 26 frigates. Subject to consultation with trade union and employee representatives, the Group announced in November that it proposes to consolidate its shipbuilding operations in Glasgow and that shipbuilding operations at Portsmouth will cease in the second half of 2014. Consultation has commenced on a total employee reduction of up to 1,775, including up to 940 in Portsmouth in 2014 and up to 835 across Filton, Glasgow and Rosyth, progressively through to 2016. The relevant cost of the restructuring will be borne by the Ministry of Defence.

A significant reduction in workload will follow the peak of activity on the aircraft carrier programme, the six Type 45 destroyers and two export contracts. The anticipated Type 26 programme will, in future years, address some of that workload reduction. In the interim period, a proposed contract for the manufacture of three Offshore Patrol Vessels was announced in November, which, as well as providing interim shipbuilding workload, will provide additional capability for the Royal Navy and sustain key shipbuilding skills.

Cumulative savings of £457m have been reported to the Ministry of Defence against commitments made under the Terms of Business Agreement (ToBA), which remains ahead of target. The agreements announced in November, together with the anticipated contract for the design and manufacture of the Type 26, will progressively replace the ToBA.

Progress continues on assembly of the first aircraft carrier, HMS Queen Elizabeth, whilst block build for the second ship, HMS Prince of Wales, is underway. BAE Systems, with the other participants in the Aircraft Carrier Alliance, announced in November that it had agreed changes to the contract to accommodate both programme changes and activities previously excluded. Under the new target cost arrangements, the industrial participants' fee includes a 50:50 risk share arrangement providing greater cost performance incentives.

HMS Duncan, the sixth and final Type 45 destroyer, was accepted by the Ministry of Defence in March. The Type 45 support contract met all ship deployment dates in the year.

The assessment phase contract for the Type 26 is proceeding and there are now over 600 employees working on the contract, which will complete in 2014.

Following the agreement in December 2011 for the sale of Offshore Patrol Vessels to the Brazilian Navy, the third and final vessel was delivered on schedule in June.

Progress continues on the Khareef Class corvettes for Oman, with the first two ships achieving interim acceptance in 2013 and the final ship scheduled for interim acceptance in 2014.

The Warship Support Modernisation Initiative contract, for delivery of services at Portsmouth Naval Base, was extended for one year in April, while discussions continue on the new Maritime Support Delivery Framework.

The Advanced Radar Target Indication Situational Awareness Navigation (ARTISAN) 3D radar programme continues towards full qualification, with the first of class now fitted to HMS Iron Duke, a Type 23 frigate, and further installations underway in line with the production plan.

The Maritime Composite Training System, a shore-based warfare operator training solution for the Royal Navy, has now achieved full operating capability. Training has been delivered to over 2,000 personnel and to warfare teams from every major warship.

HMS Astute and HMS Ambush, the first and second of class attack submarines for the Royal Navy, achieved operational handover in 2013. Artful, the third of class, is planned to launch in 2014, and a further £441m of orders have been secured for Boats 5, 6 and 7.

Progress continues on the design and development phase of the Successor submarine programme, the replacement to the Vanguard Class fleet. Over 1,300 people are now employed on this programme.



### Combat Vehicles (UK)

The Terrier® combat engineer vehicle was declared 'in service' by the Ministry of Defence in April. It is the first UK combat vehicle to enter service designed with an integrated electronic architecture which facilitates 'drive-by-wire' and remote control.

### Munitions

As part of the Munitions Acquisition Supply Solution partnering agreement, the Group has invested in a number of facility improvements across the Munitions business, including new plant and processes at its Radway Green site, which will help to save money for its customers and reduce carbon emissions. The site is Munitions' centre of excellence for the design, manufacture, proofing and supply of small arms ammunition.



### Combat Vehicles (UK)

The Terrier® combat engineer vehicle was declared 'in service' by the Ministry of Defence in April, with 43 of the 60 contracted vehicles delivered in 2013. Final vehicle deliveries are expected during the first half of 2014.

The Newcastle facility will close in the second half of 2014 following completion of final vehicle deliveries.

### Munitions

The Munitions business will be reported in the financial results of the Platforms & Services (UK) reporting segment from 1 January 2014. The business is reported in Platforms & Services (US) in 2013.

## Sustainability performance

### Safety

Naval Ships and Maritime Services both picked up International Safety Awards during 2013 from the British Safety Council, which is a reflection of a collective commitment to high standards of safety.

### Diversity and inclusion

BAE Systems in the UK works in partnership with Opportunity Now, the gender campaign from Business in the Community. The campaign's three priorities are a better gender balance for leadership progression; unbiased recognition and reward for all; and agile work cultures that are fit for the future. This supports the Group's diversity and inclusion strategic goals, including strengthening its competitive position as an attractive employer.

### Environment

At Military Air & Information's Warton and Samlesbury sites in the UK, a campaign to reduce energy usage and minimise environmental impacts used floor art to get the message across to employees. Spray-painted with biodegradable chalk, the innovative artworks highlighted how much gas and electricity the business uses and encouraged employees to think about how they could help to reduce energy consumption.

### Engagement

Mental health conditions cost UK employers billions of pounds each year. Fear of stigma and discrimination can also make people with mental health conditions unwilling to disclose their illness and thus prevent them from being adequately supported at work. Military Air & Information won a Gold BAE Systems Chairman's Award for the work it has done in developing a suite of tools, self-help material, website content and support to improve the way it deals with mental health issues.



For Group sustainability performance, see Sustainability section on pages 112 to 119

## Looking forward

Platforms & Services (UK) has a strong order backlog of long-term committed programmes and an enduring support business.

In Military Air & Information, sales are underpinned by combat aircraft production on Typhoon and F-35 Lightning II, and in-service support for existing and legacy combat and Hawk trainer aircraft. There are a number of significant opportunities to secure future Typhoon export contracts, including to Saudi Arabia, Malaysia and Bahrain.

In Maritime, sales are underpinned by the Queen Elizabeth Class aircraft carrier and Astute Class submarine manufacturing programmes, the Warship Support Modernisation Initiative contract, and the design and future manufacture of the Successor submarine and Type 26 frigate. Support of these platforms and Type 45, together with their associated command and combat systems, is expected to provide sustainable business in technical services and mid-life upgrades.

In Combat Vehicles (UK), following completion of deliveries on the Terrier® programme, sales are expected to be derived from through-life support of legacy platforms.

The Munitions business is underpinned by the 15-year Munitions Acquisition Supply Solution partnering agreement with the UK Ministry of Defence, together with a number of international contracts and potential opportunities.



# PLATFORMS & SERVICES (INTERNATIONAL)

Platforms & Services (International), with 14,600 employees<sup>1</sup>, comprises the Group's businesses in Saudi Arabia, Australia, India and Oman, together with its 37.5% interest in the pan-European MBDA joint venture.



## 2013 EXECUTIVE COMMITTEE OBJECTIVE

Grow our Platforms & Services (International) business

### KEY CHARACTERISTICS

#### Saudi Arabia

- Long-term contracts from the Royal Saudi Air Force for equipment, training and support, including Salam Typhoon aircraft
- Support to the Royal Saudi Navy minehunter programme

#### Australia

- Strategic capability and sustainment provider to the Australian Defence Force
- Delivering defence contracts across the air, land, maritime and electronics domains

#### India

- Long-standing military aircraft relationships

#### Oman

- In-service base across air, land and maritime products

#### MBDA

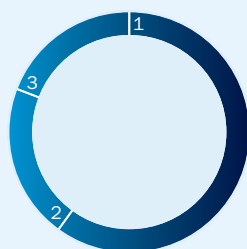
- Pan-European guided weapons joint venture



#### Saudi Arabia

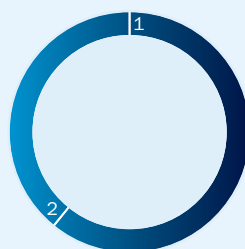
In June, BAE Systems received a follow-on order for support on the Salam Typhoon programme covering a five-year period to the end of 2017. At the end of December, the Royal Saudi Air Force fleet had flown a total of over 9,000 hours.

## Sales analysis: activity (%)



1 Saudi Arabia	60
2 Australia	21
3 Other	19

## Sales analysis: platforms and services (%)



1 Military & Technical Services	61
2 Platforms	39

## Progress on sustainability

Recordable Accident Rate	22%	↓
Major injuries		↑
Energy		↓
Water		↓
Waste		↓

		2013	2012	2011
Funded order intake <sup>1</sup>	KPI	£7,221m	£5,266m	£3,319m
Order backlog <sup>1</sup>		£12.3bn	£9.3bn	£8.3bn
Sales <sup>1</sup>	KPI	£4,063m	£4,071m	£3,794m
Underlying EBITA <sup>2</sup>	KPI	£429m	£417m	£449m
Return on sales		10.6%	10.2%	11.8%
Cash (outflow)/inflow <sup>3</sup>	KPI	£(189)m	£506m	£80m

## FINANCIAL KEY POINTS

- Order backlog<sup>1</sup> increased by 32% on multi-year support awards and weapons procurement in Saudi Arabia
- Operating cash outflow<sup>3</sup> of £189m on utilisation of customer advances and pending receipt of Salam settlement proceeds

## OPERATIONAL KEY POINTS

- Salam Typhoon price escalation negotiations concluded
- Resumption of Typhoon aircraft deliveries to Saudi Arabia under the Salam programme
- Five-year, £1.8bn output-based Salam Typhoon support contract received
- £1.5bn of orders received for Tornado aircraft upgrades and weapons procurement under the Saudi British Defence Co-operation Programme
- Integration and trials of the first Landing Helicopter Dock (LHD) in Australia ongoing
- Second LHD hull arrived in Australia for consolidation to commence in the first quarter of 2014
- Five-year, A\$342m (£185m) support contract for Royal Australian Air Force Hawk training aircraft received
- MBDA secured significant contracts with its UK and French government customers

## SUSTAINABILITY KEY POINTS

- Reduced Recordable Accident Rate by 22%
- Reduced energy and water usage, and quantity of waste produced

<sup>1</sup> Including share of equity accounted investments.

<sup>2</sup> Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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



### Saudi Arabia

Under the Tornado Sustainment Programme, weapon deliveries were completed in 2013. Orders worth £1.5bn for the upgrade of Tornado aircraft and additional weapons procurement were received under the programme.

### Australia

In 2013, a new training facility was opened for future crews of the two Landing Helicopter Docks currently under construction by BAE Systems. The ships are the largest ever to be built for the Royal Australian Navy. A 4,000 square metre warehouse has been transformed into a purpose-built, state-of-the-art base.



## Financial performance

Order backlog<sup>1</sup> has increased to £12.3bn (2012 £9.3bn) following awards in Saudi Arabia for five years of support on Typhoon and further weapons packages on Tornado, together with renewal of the Australian Hawk support programme.

Sales<sup>1</sup> of £4.1bn were almost unchanged from 2012. The deferred trading arising from the Salam price escalation and increased levels of support for Typhoon aircraft now in service were offset by reductions in the Australian business as the Landing Helicopter Dock build programme ramps down.

Underlying EBITA<sup>2</sup> of £429m (2012 £417m) generated a return on sales of 10.6% (2012 10.2%).

The operating cash outflow<sup>3</sup> reflects the utilisation of advances received in 2012 on the Saudi Tornado upgrade programme.

## Operational performance

### Saudi Arabia

Through the entry into service of Typhoon and the continued development of the in-country industrial base, the Group remains committed to developing a greater indigenous capability in Saudi Arabia.

On the Salam Typhoon programme, UK final assembly of 72 Typhoon aircraft continues. Aircraft deliveries re-commenced in April. At 31 December 2013, 34 aircraft had been delivered to the customer. Work is progressing to schedule on the provision of a multi-role capability for the aircraft.

A five-year, £1.8bn output-based contract was received to support the Royal Saudi Air Force (RSAF) Typhoon aircraft as they progressively enter into service. In addition, a four-year contract to deliver scheduled maintenance and upgrade to 30 Typhoon aircraft by the end of 2017 was received.

Discussions on Typhoon price escalation reached agreement with the Saudi Arabian government.

Under the Saudi British Defence Co-operation Programme (SBDPCP), the business continues to support the operational capability of both the RSAF and Royal Saudi Naval Forces (RSNF). Under a £1.6bn contract awarded in 2012 to upgrade the RSAF's aircrew training aircraft, the production of Hawk and Pilatus PC-21 training aircraft continues to programme. Under contracts totalling £3.4bn awarded in 2012 for support to the RSAF to the end of 2016, the first graduation ceremony of cadets from the King Faisal Air Academy took place in May.

Weapon deliveries were completed and orders worth £1.5bn for the upgrade of Tornado aircraft and additional weapons procurement were received.

Work was completed on the first ship re-fit on the RSNF minehunter mid-life update programme. The ship was accepted back into the RSNF fleet during the second half of 2013 and the second ship has entered the update programme.

### Australia

Consolidation of the first of two Landing Helicopter Docks (LHD) was completed at the Williamstown shipyard following the arrival of the hull from subcontractor Navantia in Spain. Integration and test of the ship's systems and the initial stages of ship acceptance trials are progressing. Consolidation of the second LHD hull will begin in Melbourne in the first quarter of 2014. In April, the business opened a new simulation and training facility in Sydney for training future LHD crew.

Under the Air Warfare Destroyer programme, all 11 hull blocks have been accepted by the customer and nine delivered. Seven additional blocks have now been contracted for A\$69m (£37m) and are under construction.

Under the initial ANZAC frigate anti-ship missile defence system contract awarded in 2004, the operational trials process was concluded on HMAS Perth. Under the follow-on contract awarded in 2012, the second frigate, HMAS Arunta, is continuing its refurbishment and construction to fit the new masts and systems, and the third frigate, HMAS ANZAC, is progressing through its own refurbishment and upgrade programme.

The business was awarded a five-year, A\$342m (£185m) contract, with options to extend through to 2026, to continue to support the Royal Australian Air Force Hawk Lead-In Fighter aircraft fleet.

The first upgraded AP-3C Orion maritime surveillance aircraft to be fitted with a new Electronic Support Measures system was delivered in November, marking a significant milestone in the delivery of the project to the Royal Australian Air Force.

Tigerair Australia awarded BAE Systems a five-year contract to provide base maintenance services for its fleet of Airbus A320 aircraft. The business continues to examine opportunities to expand further its commercial aviation maintenance footprint in Australia.

The business incurred operating losses on the JP 2008 Phase 3F programme which provides strategic and tactical satellite communications capabilities to support Australian Defence Force operations.

The business was not down-selected for the Defence Logistics Transformation Programme.

### India

The business sold its 26% shareholding in Defence Land Systems India to Mahindra & Mahindra, the holder of the other 74% of the shares in the joint venture.

In March, the US government issued a Letter of Acceptance to the Indian government under the US Foreign Military Sales (FMS) process for the supply of 145 M777 howitzers to the

<sup>1</sup> Including share of equity accounted investments.

<sup>2</sup> Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

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



### MBDA

In 2013, the Royal Navy of Oman conducted an operational naval VL MICA missile firing from the Al Shamikh Offshore Patrol Vessel constructed by BAE Systems. The missile successfully intercepted and destroyed the target at very low altitude.

### India

India is the largest operator of the Hawk Advanced Jet Trainer with 123 aircraft ordered to date, of which over 70 have been delivered to the Indian Air Force. In 2013, the Indian Navy received the first of 17 Hawk trainer aircraft.



Indian Army. The Indian government has yet to progress the M777 FMS case through all levels of its procurement process. As a result of this and with no other new orders for M777, in October, the business took the decision to suspend M777 manufacture in Barrow-in-Furness, UK.

A fixed-price proposal has been submitted to Hindustan Aeronautics Limited (HAL) for a third batch of Hawk trainer aircraft for the Indian Air Force and discussions with HAL continue.

Whilst the Indian government deemed Dassault to be the lowest priced compliant bidder in the Medium Multi-Role Combat Aircraft competition, contract negotiations that began in early 2012 have not been concluded. The Group continues to monitor the competition and stands ready to support the Indian government's procurement process.

### Oman

Following the signature of the contract to supply 12 Typhoon and eight Hawk aircraft in 2012, initial mobilisation has commenced. The business continues to focus on strengthening its close relationship with the Royal Oman Air Force, Navy and Army, and to address their future requirements.

### MBDA

Following publication of the 2013 Livre Blanc in France, a €433m (£360m) contract was secured from the French customer for the development and production of the Missile Milieu de Trame system. In January 2014, the UK and French governments signed an agreement worth €500m (£416m) for the joint development and production of the MBDA Future Anti-Ship Guided Weapon – Anti-Navire Léger (FASGW-ANL) missile for their armed forces.

In export markets, significant orders have been awarded in the Middle East and Far East.

MBDA continues to support the various aircraft procurement campaigns around the world and is well placed to respond to any associated weapon requirements.

## Sustainability performance

### Safety

Two employee-driven initiatives highlight the positive changes in Australia's safety culture and performance that contributed to a 29% reduction in the Recordable Accident Rate during 2013. The first was the introduction of aircraft protective edge padding and use of bump caps across the aerospace business. The second involved the development of a safety device for handling cut steel in shipyards.

### Diversity and inclusion

In 2011, the Saudi business opened a female business support centre employing locally-recruited Saudi national women for the first time. The business plans to increase the number of Saudi female employees in 2014.

In 2013, the Indian business was recognised by the Indian National Human Resource Development Network as exhibiting best practice in its programme to support career development for female employees.

### Environment

The Australian business has implemented initiatives to improve energy efficiency. At a programme office in Cairns, a 7% reduction in electricity consumption was observed in 2013 after implementing initiatives, including installing improved temperature controls to reduce the use of air conditioning. Similarly, at the Williamstown fast jet maintenance base, an 8% reduction in electricity consumption was observed in 2013 following improvements, including modifications to the air conditioning system.

### Engagement

BAE Systems Saudi Arabia increased further the Saudisation of its workforce in 2013, achieving a level of 62%. Initiatives in this area were recognised by an award from the Saudi Ministry of Labour.

The Mustakbal Management Development Programme provides leadership development and management qualifications preparing high-potential employees for executive roles within the business. In 2013, 13 employees were enrolled onto the programme.

➔ For Group sustainability performance, see Sustainability section on pages 112 to 119

## Looking forward

In the Kingdom of Saudi Arabia, the Group expects to sustain its long-term presence through delivering current programmes and industrialisation, and developing new business in support of the Saudi military and paramilitary forces.

In Australia, the change of government following a federal election in September is not anticipated to affect materially the future outlook for defence spending. The new administration has committed to the release of a revised white paper and to make, within 18 months of the election, the decisions necessary to ensure that Australia has no submarine capability gap. The Group is continuing to explore and secure opportunities in adjacent markets, particularly in the oil and gas industry in Western Australia.

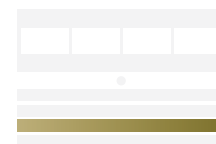
In India, aircraft and artillery opportunities continue to be pursued.

In Oman, following signature of the Typhoon and Hawk contract in 2012, the Group will work with the customer to strengthen further its close ties and to address their future requirements.

MBDA continues to build on the effective partnerships it has established with its domestic customers and is actively pursuing a significant number of export opportunities.



# SUSTAINABILITY SUMMARY



BAE Systems manages the current impacts of its operations and products, and anticipates the future global business environment to ensure that it has processes in place to support the long-term sustainability of the Group.

Sustainability of our reputation and our licence to operate is an integral part of the Group's business model. It is focused on embedding responsible business behaviours and placing emphasis not just on what the Group does, but how it is done.

The Group focuses on the areas identified by internal and external stakeholders as having the greatest potential to affect the long-term sustainability of the business, by directly impacting the Group's reputation or ability to operate. The areas identified that shape the Group's sustainability objectives and programmes are high priorities for the Group.

## A culture of integrity

BAE Systems continues to embed its ethics programme globally, driving the right behaviours by supporting employees in making ethical decisions and embedding responsible business practices.

The Group's Code of Conduct sets out the principles and standards of business conduct expected of all employees. It provides them with practical guidance on how to deal with situations that may arise in their day-to-day activities.

Clear governance structures and visible leadership play a vital role in embedding corporate responsibility.

The Group's governance framework, as described in the Operational Framework, covers the products we make and export. The Group's Responsible Trading Principles, Product Trading Policy and Pursuit of Export Opportunities Policy help employees make informed decisions about the business opportunities the Group pursues and to address any responsible trading risks, including risks associated with the product and its intended end use, the country of origin and delivery, and the customer.

The Group is committed to respecting human rights in its operations, within its sphere of influence.

## An inspired workforce

BAE Systems recognises that its employees are key to delivering the Group's strategy successfully and sustaining future business.

### People development

The Group's people strategy of through-career capability development and emphasis on high levels of employee engagement seeks to maximise the contribution that its workforce makes to the performance of the business.

The success of this strategy is measured ultimately in the success of the business as a whole.

### Diversity and inclusion

BAE Systems is committed to creating an inclusive work environment where a diverse range of talented people can work together to ensure business delivery. Diversity amongst the Group's workforce is a significant force for innovation and assists the Group in responding to customer requirements.

At the end of 2013, three (27%) and two (17%) of the Board and Executive Committee members, respectively, were women. Globally, 59 (15%) and 15,000<sup>1</sup> (20%) of the Group's senior managers<sup>2</sup> and total workforce are women, respectively.

### Employee safety

Safety of the Group's employees, and anybody who works on its sites, is a key priority. The Group continues to embed a safety first approach by providing training and tools that help employees understand the importance of a safe workplace, and encouraging employees to take responsibility for their own safety and the safety of those around them. The senior leadership of the Group plays a key role in maintaining the focus on safety and leading through example.

## Responsible environmental management

### Operational

The Group's goal is to reduce the environmental impact of its operations

and products by using energy, water and waste more efficiently.

Businesses across the Group have environmental management systems in place that monitor and manage impacts from greenhouse gas emissions, material and solvent use, waste products, and emissions to the atmosphere.

### Product

Environmental considerations are taken into account throughout a product's lifecycle from concept, design and manufacture through to use and disposal via the Group's Lifecycle Management (LCM) process (see page 69). This includes reducing the environmental impacts of the Group's products during research and development, minimising waste materials during manufacturing, and helping to reduce the impact of our products when they are used, upgraded or disposed of.

## Product stewardship

The Group's Research & Development (R&D) activities cover a wide range of programmes, and include technological innovations and techniques to improve the manufacturing and service of products. In 2013, R&D expenditure was £1,051m (2012 £1,138m) of which £171m (2012 £150m) was funded by the Group.

It is critical that the Group's products perform as designed without harm to the people using them. No complex and innovative product, whether used in defence or civilian markets or both, is without risk. It is essential that the Group achieves an appropriate balance between the benefits they provide to customers and the risks associated with their use.

## Community investment

BAE Systems' Global Community Investment Strategy is defined through the support it provides both financial and through volunteering. BAE Systems aims to align its resources in support of primary areas of focus – the needs of the Group's customers, education and skills, heritage and the communities in which the Group operates.

<sup>1</sup> Excluding equity accounted investments and rounded to the nearest thousand employees.

<sup>2</sup> Senior managers are defined as employees who have responsibility for planning, directing or controlling the activities of the Group or a strategically significant part of the Group and/or who are directors of subsidiary undertakings.



### Safety

SHEZINE is a tool that has been launched on the UK intranet site in order that employees across the UK can share best practice in safety, health and environment, and highlight areas of concern in the workplace.



### Unconscious bias training

Unconscious bias training was rolled out during 2013. The concept of unconscious bias is an important component of an inclusive culture because it alters the way people think, both positively and negatively, and how they view and evaluate others. Employees participated in discussions on video workplace scenarios.

## 2013 priorities

### Ethics and governance

- Continue to improve and evolve the Group's business conduct programme.

### Employee safety and wellbeing

- Demonstrate improvements against key safety indicators, including a 10% improvement in the Recordable Accident Rate.

### Diversity and inclusion

- Increase diversity and inclusion within the organisation in accordance with business goals.

### Operational environmental impacts

- Set environmental improvement targets to include energy, water and waste.

## 2013 progress

- Network of Ethics Officers established across all operations.
- Training provided for all senior employees on export control procedures, and anti-bribery and corruption.
- Employee survey confirmed that the senior leadership of the Group is committed to ethical business practices and conduct.

- The Group achieved a 17% reduction in the Recordable Accident Rate in 2013.
- The number of major accidents increased compared with 2012, prompting detailed reviews and investigation by senior management.
- Health and wellbeing initiatives were rolled out across the US, UK and Australian businesses focusing on both physical and mental issues.

- Unconscious bias training rolled out for all employees through online training and management-led engagement sessions.
- BAE Systems' progress in increasing female representation has been recognised by external organisations.

- All businesses set, and the majority met, improvement targets for energy, water and waste.
- The Group developed a more mature approach to capturing carbon emissions data across the business.

## 2014 priorities

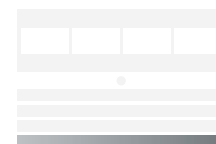
- Continue to improve and evolve the Group's business conduct programme.
- Undertake external assessment of ethical culture and environment.

- Continue the drive towards a world-class level of safety.
- Use benchmarking against leading companies to identify key areas for improvement and focus.

- Increase diversity and inclusion within the organisation in accordance with business goals.
- Diversity and inclusion plans to be aligned with business plans and Key Performance Indicators identified for monitoring and tracking against plans.

- Set environmental improvement targets to include energy, water and waste.

# GOVERNANCE SUMMARY



“Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.”

UK Corporate Governance Code

## Board appointments

The Nominations Committee is responsible for managing the orderly succession of appointments to the Board. In discharging this role, it reviews the balance of skills and experience on the Board regularly, and manages the process of identifying suitable candidates for appointment.

➔ See Nominations Committee report on page 79

During 2013, the Board appointed Sir Roger Carr to succeed Sir Richard Olver as Chairman. The search for a suitable candidate to succeed Sir Richard was led by the Nominations Committee, which for this purpose was chaired by the Company's Senior Independent Director, Nick Rose. He engaged with key stakeholders, including major shareholders, throughout the process.

Sir Roger Carr is an experienced company director, having served as chairman on a number of large listed company boards, most recently as chairman of Centrica plc. At present, he is also deputy chairman and senior independent director of the Court of the Bank of England and a member of the UK Prime Minister's Business Advisory Group. In accordance with the requirements of the UK Corporate Governance Code, Sir Roger was independent as at the date of his appointment.

Jerry DeMuro was appointed to the Board on 1 February 2014 having succeeded Linda Hudson as President and Chief Executive Officer of the Group's US business. Mr DeMuro is an experienced US executive who has worked in the national security, technology and aerospace industry for over 30 years. Most recently, he served as executive vice president and corporate vice president of General Dynamics' Information Systems and Technology Group.

Two independent non-executive directors, Ian Tyler and Chris Grigg, also joined the Board during the year.

In line with best governance practice, all the members of the Board will seek re-election by shareholders at the Company's Annual General Meeting.

The above changes to the Board had a negative impact on its gender diversity. At present, 18% of directors are women (2013 27%). However, the Board remains committed to an aspirational target of at least 25% of its members being women by 2015.

➔ See Corporate governance report on page 69

## Accountability

The UK government introduced new requirements for company reporting during 2013. These changes provide an opportunity for boards to improve the quality of reporting on their stewardship of the company. In line with the new requirements, the Board has taken the opportunity to revise its reporting with greater emphasis on producing a focused analysis of the performance of the Company in the Strategic Report. In addition, it has considered the requirement in the UK Corporate Governance Code for narrative reports to be 'fair, balanced and understandable', and how directors can ensure that they are in a position to make a timely and well-informed determination on this matter. The Board has reviewed the process for the drafting of the Annual Report and the assurance process used to verify its accuracy and completeness. All Board members have participated in reviewing and commenting on drafts of the report to help ensure that the final publication meets the 'fair, balanced and understandable' requirement.

## Remuneration

After a wide-ranging debate in 2013 that engaged many stakeholders, the UK government enacted regulations that have changed significantly the requirements concerning directors' remuneration and the role that shareholders play in agreeing a policy on directors' pay and the maximum payable. The policy agreed and proposed by the Board's Remuneration Committee is the result of a detailed review that began with a wide-ranging discussion and analysis of what it wished to achieve regarding executive pay and the various remuneration structures that could be employed. The views of the Company's major shareholders were sought during this process.

As required by the new regulations, the directors' remuneration policy as detailed in this Annual Report will be put to shareholders for their approval at this year's Annual General Meeting.

➔ See Remuneration Committee report on page 80

## Corporate responsibility

In 2013, five years after the publication of Lord Woolf's Report on ethical business conduct in BAE Systems plc, the Board and the Corporate Responsibility Committee both reviewed the status of ethical business matters across the Company. It was recognised that a great deal had been achieved in that period through positive leadership from the Board downwards. However, it was recognised that the Board needed to remain vigilant in its oversight of ethical business conduct matters so as to ensure that standards are maintained over the long term and that the Company continues to be at the forefront in this area. The Corporate Responsibility Committee agreed additional activities to help secure a lasting legacy of leadership in the area of responsible business behaviour.

➔ See Corporate Responsibility Committee report on page 77

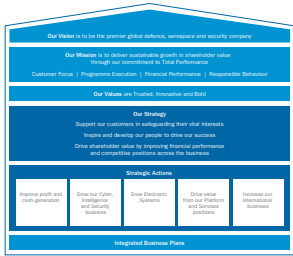
## Board performance evaluation

Each year, the Board uses an external facilitator to assist in reviewing its effectiveness. Directors discuss the feedback from this process and agree objectives aimed at ensuring that the Board remains effective and at the forefront in developing and applying best practice in the boardroom. A review of performance against 2013 objectives is presented opposite.

## Code compliance

The Company was compliant with the provisions of the UK Corporate Governance Code throughout 2013 and the Board has applied its principles in its governance structure and operations.

➔ See Corporate governance report on page 69



As part of its annual strategy review, the Board reviewed the significant risks that could affect the achievement of the strategy and business plan.

➔ See Group Strategic Framework on page 7



The Nominations Committee and the Board reviewed the Group's management resource plans, including the strategy and actions being pursued to achieve greater diversity across the Group's workforce.

2013 objectives
<b>Strategy</b> <ul style="list-style-type: none"><li>■ Continue the strategic review of the business portfolio, focusing on the services businesses.</li><li>■ Work with the executive team in the development of a comprehensive narrative of the Company's strategy.</li></ul>
<b>Succession planning</b> <ul style="list-style-type: none"><li>■ The Nominations Committee to complete the recruitment of two additional non-executive directors and identify a world-class candidate to succeed Sir Richard Olver as Chairman.</li></ul>
<b>Risk and risk management</b> <ul style="list-style-type: none"><li>■ The Board to continue to review cyber security protection, the management of risk in major programmes and crisis management.</li><li>■ Ensure that the Company remains at the forefront of developing and embedding best practice in responsible business behaviour.</li></ul>
<b>Board development</b> <ul style="list-style-type: none"><li>■ Enhance the Board's strategic understanding of geo-political and economic risks in international markets.</li><li>■ Use Board visits to promote understanding of markets and the business development opportunities they offer.</li></ul>

2013 achievements
<ul style="list-style-type: none"><li>■ The Board undertook a detailed review of the business portfolio at a strategy meeting held in June and again in November as part of its annual Integrated Business Planning process.</li><li>■ The Company developed its strategic narrative further during the year.</li></ul>
<ul style="list-style-type: none"><li>■ Ian Tyler and Chris Grigg were appointed to the Board as non-executive directors. Sir Roger Carr was appointed to succeed Sir Richard Olver as Chairman.</li></ul>
<ul style="list-style-type: none"><li>■ The Board spent time with the Company's Chief Information Officer reviewing cyber security protection. Directors also reviewed risk management on a major programme and Board communications were included as part of a crisis management exercise.</li><li>■ The Board and Corporate Responsibility Committee reviewed responsible business conduct and agreed a number of actions, including a survey of employee opinions, similar to that undertaken by the Ethical Leadership Group in 2011.</li></ul>
<ul style="list-style-type: none"><li>■ One of the Board's meetings in 2013 was held in India. Meetings with members of our local advisory board and local industrial partners were used to develop directors' understanding of the market.</li></ul>

2014 objectives
<ul style="list-style-type: none"><li>■ Focus on developing a more detailed strategic understanding of the Company's businesses and markets.</li><li>■ Ensure that the strategy for the Company's Applied Intelligence business is optimised to access fully the growth potential of the cyber security market.</li></ul>
<ul style="list-style-type: none"><li>■ Engage with all directors on executive development and succession planning.</li><li>■ Increase the levels of diversity and bench strength in key roles and make progress against the Company's diversity objectives.</li></ul>
<ul style="list-style-type: none"><li>■ The Board to continue reviewing the level of risk it is willing to take in achieving its strategic objectives.</li></ul>
<ul style="list-style-type: none"><li>■ Develop a wider understanding by all directors of the use and management of commercial offset arrangements.</li><li>■ Use site visits by individual non-executive directors to help develop a deeper understanding of the Company.</li></ul>

➔ FOR A MORE DETAILED REVIEW OF GOVERNANCE, GO TO PAGES 69 TO 81 OF THE GOVERNANCE SECTION



# GOVERNANCE

## WHAT YOU WILL FIND IN THIS SECTION

### **67** BOARD OF DIRECTORS

Biographical details of each director, including their skills and experience, and other appointments.

### **69** CORPORATE GOVERNANCE REPORT

A report on compliance with the UK Corporate Governance Code, including how the Company has applied the principles in the Code.

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A report describing how the Audit Committee has discharged its responsibilities.

### **77** CORPORATE RESPONSIBILITY COMMITTEE REPORT

A report describing how the Corporate Responsibility Committee has discharged its responsibilities.

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A report describing how the Nominations Committee has discharged its responsibilities.

### **80** REMUNERATION COMMITTEE REPORT

A report by the Chairman of the Remuneration Committee summarising governance arrangements, key decisions and the context in which they were made.

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The policy in respect of directors' remuneration as proposed by the Board for approval by shareholders at the Annual General Meeting.

### **92** ANNUAL REMUNERATION REPORT

Information on the remuneration paid to the directors during 2013, including a single total figure in respect of each director.

# BOARD OF DIRECTORS

## Chairman



**Sir Roger Carr** Chairman

*Appointed to the Board:* 2013

*Nationality:* British

**Skills and experience:** Appointed to the Board on 1 October 2013 as Chairman designate, Sir Roger succeeded Sir Richard Oliver as Chairman on 1 February 2014. He was chairman of the Board of Centrica plc from 2004 until he stepped down from that role on 31 December 2013. He has previously held a number of senior appointments including chairman of Cadbury plc, Thames Water plc and Mitchells & Butlers plc, and President of the Confederation of British Industry. Throughout his career, he has served on a number of external committees, including the Higgs Committee on Corporate Governance and Business for New Europe.

**Other appointments:** He remains deputy chairman and senior independent director of the Court of the Bank of England and is a member of the UK Prime Minister's Business Advisory Group. He is also a senior adviser to Kohlberg Kravis Roberts and a trustee of the Landau Forte Charitable Trust. He is a fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, and a visiting fellow to the Said Business School, Oxford.

**Committee membership:** Chairman of the Nominations Committee and the Non-Executive Directors' Fees Committee

## Executive directors



**Ian King** Chief Executive

*Appointed to the Board:* 2007

*Nationality:* British

**Skills and experience:** Appointed as Chief Executive in 2008 having been originally appointed to the Board as Chief Operating Officer, UK and Rest of the World. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Prior to the BAe/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems.

**Other appointments:** Non-executive director and Senior Independent Director of Rotork p.l.c.

**Committee membership:** Non-Executive Directors' Fees Committee



**Jerry DeMuro** President and Chief Executive Officer of BAE Systems, Inc.

*Appointed to the Board:* 2014

*Nationality:* US

**Skills and experience:** Appointed to the Board on 1 February 2014 as President and Chief Executive Officer of BAE Systems, Inc. following the retirement of Linda Hudson, Jerry DeMuro is an experienced US executive who has worked in the national security, technology and aerospace industry for over 30 years. Most recently he served as executive vice president and corporate vice president of General Dynamics' Information Systems and Technology Group, leading a diverse portfolio focused on secure mobile communication systems, information technology solutions and mission support services, and intelligence, surveillance and reconnaissance systems. Earlier in his career, he spent almost a decade as an acquisition official at the US Department of Defense.

**Committee membership:** Non-Executive Directors' Fees Committee



**Peter Lynas** Group Finance Director

*Appointed to the Board:* 2011

*Nationality:* British

**Skills and experience:** Peter Lynas, a qualified accountant, was appointed to the Board as Group Finance Director in 2011. He previously served for a number of years as Director, Financial Control, Reporting & Treasury. He joined GEC-Marconi in 1985 having previously worked for other companies in the UK and Europe. After progressing through a number of positions he was appointed Finance Director of GEC's Marconi Electronic Systems business, which was subsequently acquired by British Aerospace in 1999 to become BAE Systems.

## Non-executive directors

**Paul Anderson** Non-executive director*Appointed to the Board:* 2009*Nationality:* US

**Skills and experience:** Paul Anderson has extensive global business experience in the energy and mining sectors. He spent more than 20 years in two spells at Duke Energy Corporation and its predecessor companies, culminating in his appointment as Chairman, President and Chief Executive Officer. He was subsequently Chairman of Spectra Energy Corporation until 2009 and in the intervening period he served as Managing Director and Chief Executive Officer of BHP and, subsequently, of the newly merged BHP Billiton.

**Other appointments:** Non-executive director of BP p.l.c.**Other past appointments:** Non-executive director of BHP Billiton Plc, Qantas Airways Limited and Spectra Energy Corporation**Committee membership:** Chairman of the Corporate Responsibility Committee and member of the Nominations Committee**Harriet Green OBE** Non-executive director*Appointed to the Board:* 2010*Nationality:* British

**Skills and experience:** Appointed as Chief Executive Officer and executive director of Thomas Cook Group plc in 2012. She was previously Chief Executive Officer and executive director of Premier Farnell plc, a leading, high service, multi-channel technology distribution group. Harriet Green has significant global business experience having run volume distribution businesses in four continents for Premier Farnell and volume distributor, Arrow Electronics, Inc. She is a member of the UK Prime Minister's Business Advisory Group.

**Other appointments:** Non-executive director of Emerson Electric Co.**Committee membership:** Corporate Responsibility Committee**Chris Grigg** Non-executive director*Appointed to the Board:* 2013*Nationality:* British

**Skills and experience:** Chris Grigg was appointed to the Board as a non-executive director on 1 July 2013. He is Chief Executive of The British Land Company PLC and has more than 30 years' experience in the financial and real estate industries in a range of leadership roles. Prior to joining British Land as its Chief Executive in 2009, he was an executive with Barclays Bank and previously spent over 20 years at Goldman Sachs where he rose to the position of partner.

**Committee membership:** Remuneration Committee**Paula Rosput Reynolds** Non-executive director*Appointed to the Board:* 2011*Nationality:* US

**Skills and experience:** Paula Rosput Reynolds is Chief Executive Officer and President of the business advisory group, PreferWest, LLC. She had previously spent over 20 years in the energy sector in a variety of operational roles, culminating in her appointment as President and Chief Executive Officer of AGL Resources in 2002. She subsequently served as President and Chief Executive Officer of Safeco Corporation, an insurance company located in Seattle, Washington, until its acquisition by Liberty Mutual Group in 2008. She was then appointed as Vice Chairman and Chief Restructuring Officer of American International Group, Inc. (AIG) from October 2008 to September 2009, overseeing AIG's divestiture of assets and serving as chief liaison with the Federal Reserve Bank of New York.

**Other appointments:** Non-executive director of Delta Air Lines, Inc., Anadarko Petroleum Corporation and TransCanada Corporation**Other past appointments:** Non-executive director of Coca-Cola Enterprises, Inc. and Air Products and Chemicals, Inc.**Committee membership:** Audit Committee**Nick Rose** Non-executive director and Senior Independent Director*Appointed to the Board:* 2010*Nationality:* British

**Skills and experience:** Nick Rose held the position of Chief Financial Officer of Diageo plc for over ten years until October 2010 where, in addition to his finance responsibilities, he was also responsible for supply, procurement, strategy and IT on a global basis. His financial experience has encompassed a number of roles since joining Diageo's predecessor company, Grand Metropolitan, in 1992, including group treasurer and group controller, having spent his earlier career with Ford Finance. He assumed the chairmanship of the Company's Audit Committee in 2011 and was appointed as the Company's Senior Independent Director in January 2013.

**Other appointments:** Chairman of Williams Grand Prix Holdings PLC. Non-executive director of BT Group plc**Other past appointments:** Non-executive director of Edwards Group Limited, Moët Hennessy SNC and Scottish Power plc**Committee membership:** Chairman of the Audit Committee, and member of the Nominations Committee and Remuneration Committee**Carl Symon** Non-executive director*Appointed to the Board:* 2008*Nationality:* British/US

**Skills and experience:** Carl Symon has an extensive background in global business operations and management, retiring in 2001 after a long career at IBM during which he held senior executive positions in the US, Canada, Latin America, Asia and Europe, including that of Chairman and Chief Executive Officer of IBM UK.

**Other appointments:** Non-executive director of Thomas Cook Group plc**Other past appointments:** Non-executive director of BT Group plc, Rexam PLC and Rolls-Royce Group plc, and Chairman of HMV Group plc**Committee membership:** Chairman of the Remuneration Committee**Ian Tyler** Non-executive director*Appointed to the Board:* 2013*Nationality:* British

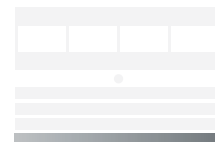
**Skills and experience:** Ian Tyler was appointed to the Board as a non-executive director on 8 May 2013. He served as Chief Executive of Balfour Beatty plc for a period of eight years stepping down from that position in 2013. A Chartered Accountant, he joined Balfour Beatty as Finance Director in 1996 having spent his earlier career in a variety of finance roles.

**Other appointments:** Chairman of Bovis Homes Group PLC and Al Noor Hospitals Group plc and a non-executive director of Cairn Energy PLC and Cable & Wireless Communications Plc**Other past appointments:** Non-executive director of VT Group plc**Committee membership:** Audit Committee and Corporate Responsibility Committee

## Company Secretary

**David Parkes**

# CORPORATE GOVERNANCE REPORT



## Independence

The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the UK Corporate Governance Code (the Code). Each of these directors has been identified on pages 67 and 68 of this report.

The Board appointed Nick Rose to succeed Sir Peter Mason as its Senior Independent Director with effect from 21 January 2013.

During the year, Mr Symon was appointed a non-executive director of Thomas Cook Group plc of which Ms Green is Chief Executive Officer and executive director. The directors have examined the effect of this appointment on their roles as non-executive directors of BAE Systems plc and are satisfied that at this time Mr Symon and Ms Green are independent for the purposes of paragraph B.1.1 of the Code. The directors will review this position annually to ensure the passage of time and deeper engagement in either business does not undermine the independence criteria.

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, the Board has agreed that in compliance with the Code, all directors shall seek re-election on an annual basis.

## Risk management and internal control

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

BAE Systems has developed a system of internal control that was in place throughout 2013 and to the date of this report, that encompasses, amongst other things, the policies, processes, tasks and behaviours that, taken together, seek to:

- facilitate the effective and efficient operation of the Company;
- enable it to respond appropriately to significant operational, financial, compliance and other risks that it faces in carrying out its business;
- assist in ensuring that internal and external reporting is accurate and timely, and based on the maintenance of proper records supported by robust information-gathering processes; and
- assist in ensuring that the Company complies with applicable laws and regulations at all

times, and also internal policies in respect of the standards of behaviour and conduct mandated by the Board.

On pages 29 and 30 of this report, you will find details of the processes the Company has put in place to manage risk. For the Board, the key requirements are that the Company has robust processes to identify, evaluate and manage risk, and that the directors have visibility of the major risks.

Risks are identified on a 'bottom-up' basis as part of the Company's Operational Assurance Statement (OAS) process. This process is mandated across the Group, and requires that the heads of all businesses and functions identify their key risks. As part of this process, an assessment is made of the probability of the risk arising and its potential impact on the Group's business plan. All risks have an owner who is responsible for preparation and implementation of plans aimed at mitigating the risk.

The key financial and non-financial risks identified by the businesses 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.

Management responsibility for the management of the Group's most significant non-financial risks is determined by the Executive Committee. The OAS and Non-financial Risk registers are reviewed regularly by the Executive Committee to monitor the status and progression of mitigation plans, and these key risks are reported to the Board on a regular basis.

The Audit Committee is responsible for reviewing the ongoing effectiveness of the Company's risk management processes as part of its review of the effectiveness of internal controls. Also, twice a year, the Audit Committee receives reports on the output from the OAS process, details of the changes in the risks identified by it and the status of mitigation plans. The Corporate Responsibility Committee undertakes a similar role in respect of the Non-financial Risk Register. The Board receives reports from the chairmen of these two committees, providing details of the work they have undertaken.

Each year, the Board specifically reviews the risks identified by the risk management processes. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

Reporting within the Company is structured so that key issues are escalated through the management team, ultimately to the Board if appropriate. The Operational Framework provides a common framework across the Company for operational and financial controls, and is reviewed on a regular basis by the Board. The business policies and processes detailed within the Operational Framework draw on global best practice and their application is mandated across the organisation. Lifecycle Management (LCM) is such a process, and promotes the application of best practice programme execution and facilitates continuous improvement across the Group. It considers the whole life of projects from inception to delivery into service and eventual disposal, and its application is critical to the Group's 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 a five-year business plan for each business, 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, intellectual and physical property, and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The Internal Audit team, which is managed independently from management functions, reviews the risk identification procedures and control processes implemented by the Company. It provides 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 Audit 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 OAS process.

The OAS process is formed of two parts: a self-assessment of compliance with mandated policies and processes; and a report showing key risks for each business and function. Managed by the Group's Internal Audit function, an OAS return must be completed every six months by each operational and functional business head, recording their formal review against such matters as compliance with law and regulation, ethical business conduct, financial controls, risk management, compliance with business planning processes, health and safety, conflicts of interest, delegated authorities, appointment of advisers and product safety. Where simple yes/no answers are not appropriate, an assessment of compliance is required to be made against structured qualitative guidance.

A separate OAS is required to be completed by the most senior BAE Systems employee responsible for joint ventures and BAE Systems employees on the boards of these companies are required to exert such influence as the Company may have to encourage the adoption of a governance structure that is substantially equivalent to that mandated for wholly owned or controlled parts of the Group.

The Audit and the Corporate Responsibility committees review the output from the OAS process with the head of Internal Audit. It is also shared in detail with the Company's auditors.

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.
























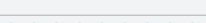
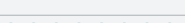





The responsibility for internal control procedures with joint ventures and other collaborations rests, on the whole, with the senior management of those operations.



#### 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 Segmental performance section on pages 36 to 61. The financial position of the Group, including information on cash flow, can be found in the Group financial performance section on pages 32 to 35. Principal risks are detailed on pages 106 to 111. In addition, the financial statements include, amongst other things, notes on finance costs (page 135), loans and overdrafts (page 160), and financial risk management, including treasury policies on interest rate, liquidity, credit and currency risks (page 175).

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.

#### Attendance by individual directors at meetings of the Board and its committees in 2013

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Paul Anderson		—			—
Sir Roger Carr		—	—	—	—
Harriet Green		—		—	—
Chris Grigg		—	—	—	
Linda Hudson		—	—	—	—
Ian King		—	—	—	—
Peter Lynas		—	—	—	—
Sir Peter Mason					—
Lee McIntire		—	—	—	
Sir Richard Oliver		—	—		—
Paula Rosput Reynolds			—	—	—
Nick Rose			—		
Carl Symon		—	—	—	
Ian Tyler				—	—

 Meetings attended  
 Meetings eligible to attend but not attended

### Applying the principles of the UK's Corporate Governance Code

The following report details how the Board has applied the main principles in the Financial Reporting Council's UK Corporate Governance Code (the Code), as required by the UK Listing Rules.

#### Leadership Principles

- An effective board collectively responsible for the long-term success of the company
- A clear division of responsibilities at the head of the company between the running of the board and the executive. No one individual should have unfettered powers of decision
- The chairman is responsible for the leadership of the board and ensuring its effectiveness in all aspects of its role
- Non-executive directors should constructively challenge and help develop proposals on strategy

The Company's governance structure is based on the leadership principles in the Code. The core activities of the Board and its committees are documented and planned on an annual basis, and this forms the basic structure within which the Board operates. The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that reflect principles contained in the Code, and covers 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 details the separate and distinct roles of the Chairman and the Chief Executive, and also those of the Senior Independent Director and Company Secretary. It also states that the following matters are reserved specifically for the Board:

1. Approving the Company's vision, values, principles of ethical conduct, delegated authorities and overall governance structure.
2. Approving all financial and commercial matters that it has reserved for its decision.
3. Approval of the Company's strategy and business plan.
4. Approval of the Company's Annual Report and Accounts, and the preliminary and interim statements.
5. Approval of any distributions to shareholders, including the approval of any interim dividend payments and any recommendations to shareholders concerning final dividends.
6. Approval of any significant changes to accounting policies or practices.
7. Appointment or removal of any director or the Company Secretary.
8. Approval of all circulars, prospectuses and other documents sent to shareholders (except for documents of a routine nature).
9. Approving the issuing and allotment of shares, changes to the capital structure of the Company, its legal status as a public company, the listing of its shares and its name.
10. Recommending to shareholders the appointment, re-appointment or removal of the Company's auditors.
11. Forming committees of the Board and approving their terms of reference.
12. Approval of the Board Charter (including this schedule of reserved matters) and the Operational Framework (a document detailing the Company's vision, values, delegated authorities and overall governance structure).

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.

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. To ensure that non-executive directors can constructively challenge and help develop proposals on strategy, the Board has adopted a process of reviewing the development of strategy and formally approving the agreed strategy for the Company on an annual basis. In 2013, the Board members were provided with opportunities to engage in strategy development through informal meetings and workshops as well as formal Board meetings.

#### Effectiveness Principles

- Board and committees having an appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively
- A formal, rigorous and transparent procedure for the appointment of new directors
- All directors to be able to allocate sufficient time to the company to discharge their responsibilities effectively
- All directors to receive induction on joining and should regularly update and refresh skills and knowledge
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties
- The board should undertake a formal and rigorous annual evaluation of its performance, and that of its committees and individual directors
- All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance

Succession planning is used by the Board to deliver two key responsibilities, firstly to ensure that the Group is managed by executives with the necessary skills, experience and knowledge, and secondly to ensure that the Board itself has the right balance of individuals to be able to effectively discharge its responsibilities. The Nominations Committee has specific responsibilities in this area but the Board as a whole is also involved in overseeing the development of management resources in the Group with the aim of ensuring it has the individuals with the right skills to meet the needs of an increasingly complex and global business. The procedures for the appointment of non-executive and executive directors are detailed in the Nominations Committee report.

Following review by the Nominations and Corporate Responsibility committees, the Board adopted the statement shown below to act as a guide to future Board succession planning activity and to make a clear public statement of its support for greater diversity in the boardroom.

- The Board has an aspirational target of at least 25% of the Board being women by 2015.
- In seeking candidates for appointment to the Board, the Nominations Committee will only engage the services of search consultants who have open and inclusive recruitment processes that draw from an appropriately diverse pool of candidates.
- The Board will report progress against targets and actions taken in the Annual Report and Accounts.

There are currently two women on the Board (2013 three), 18% (2013 27%) of the total membership. There are two women on the Executive Committee (2013 three), 17% of its total membership (2013 25%), and 20% of the Group's employees are women (2013 20%).

Further information on diversity can be found on page 114.

For a number of years, the Board's annual effectiveness evaluation has been undertaken by an external facilitator, Sheena Crane. She is an experienced board performance 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.

Individual directors are also subject to annual performance evaluation, and the Chairman meets with each director and provides feedback on a one-to-one basis. Committee chairmen also receive feedback on committee performance. Feedback on the Chairman's performance is provided directly by the facilitator to the Senior Independent Director, who discusses this with other non-executive directors before holding a one-to-one with the Chairman. Subject to continued satisfactory performance, directors seek re-election on an annual basis.

On appointment, all non-executive directors are advised of the likely time commitments and are asked to seek approval from the Nominations Committee if they wish to take on additional external appointments. The ability of individual directors to allocate sufficient time to the discharge of their responsibilities is, where necessary, considered as part of the directors' annual evaluation process overseen by the Chairman. An induction programme is agreed for all new directors aimed at ensuring that they are able to develop an understanding and awareness of the Company's core processes, its people and businesses. In addition, 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. Ongoing training is provided for the Board and individual directors as required.

The Chairman, with the assistance of the Chief Executive and Company Secretary, is responsible for ensuring that directors are supplied with information in a timely manner that is in a form and of a quality appropriate to enable them to discharge their duties. In the normal course of business, such information is provided by the Chief Executive in a regular report to the Board that includes information on operational matters, strategic developments, reports on the performance of Group operations, financial performance relative to the business plan, business development, corporate responsibility and investor relations.

#### **Accountability Principles**

- The board to present a balanced and understandable assessment of the company's position and prospects
- The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems
- The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor

Through this report and, as required, through other periodic financial statements, the Board is committed to providing shareholders with a clear assessment of the Company's position and prospects. The arrangements established by the Board for the application of risk management and internal control principles are detailed on page 69. The Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors, further details of which can be found in the Audit Committee report on page 74.

## Remuneration

### Principles

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance
- There should be a formal and transparent procedure for developing policy on executive remuneration, and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration

The Board has delegated to the Remuneration Committee responsibility for agreeing remuneration policy, and the individual remuneration of the executive directors, the Chairman, members of the Executive Committee and the Company Secretary (see Remuneration Committee report on pages 80 and 81). The Committee is formed exclusively of independent non-executive directors.

## Relations with shareholders

### Principles

- There should be a dialogue with shareholders based on the mutual understanding of objectives
- The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place
- The board should use the AGM to communicate with investors and to encourage their participation

The Company has a well-developed investor relations programme managed by the Chief Executive, Group Finance Director and Investor Relations Director. In addition, the Chairman is available to meet with major shareholders and is in regular contact with them so as to keep them informed of progress on corporate governance matters. In order to assist in developing an understanding of the views of major shareholders, each year the Company commissions a survey of investors undertaken by external consultants. The results of the survey are presented to the Board.

The Company maintains a comprehensive Investor Relations website that provides, amongst other things, information on investing in BAE Systems and copies of the presentation materials used for key shareholder presentations. This can be accessed via the Company's website, [www.baesystems.com](http://www.baesystems.com). The Company's AGM provides all shareholders with the opportunity to vote on the resolutions put to shareholders either electronically via the Company's website or by post. All resolutions detailed in the Notice of Meeting are voted on by way of a poll so as to ensure that all votes are counted on the basis of one vote for every share held. The result of the voting on all resolutions is published on the Company's website.



# AUDIT COMMITTEE REPORT



**Nick Rose**  
Chairman of the Audit Committee

## Members

Nick Rose (Chairman)  
Paula Rosput Reynolds  
Ian Tyler

## Governance

The Audit Committee was in place throughout 2013 and held six meetings, plus one joint meeting with the Corporate Responsibility Committee. All its members are independent in accordance with the provisions of the Code. Sir Peter Mason served as a member of the Committee until 8 May 2013 when he retired from the Board; Ian Tyler joined the Committee on the same date on his appointment to the Board; and Nick Rose and Paula Rosput Reynolds served throughout the year.

## Summary of 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 and Interim Management Statements
- Monitoring the role and effectiveness of the Internal Audit function
- Approving an annual programme of internal audit work
- Making recommendations to the Board on the appointment of the Auditors
- Agreeing the scope of the Auditors' annual audit programme and reviewing the output
- Keeping the relationship with the Auditors under review
- Assessing the effectiveness of the audit process
- Developing and implementing policy on the engagement of the Auditors to supply non-audit services

The Committee's full Terms of Reference, which are reviewed each year by the Board, are available on the Company's website.

## Attendance at meetings

The Committee invites the following to its regular meetings:

- Chief Executive; Group Finance Director; and Director, Financial Control and Reporting;
- Internal Audit Director;
- other representatives from businesses and functions, as appropriate; and
- the senior KPMG partner responsible for the BAE Systems audit, together with other senior audit partners, as appropriate.

The Committee holds private sessions with the Auditors and Internal Audit Director without management present, and the Committee Chairman meets privately with both internal and external audit.

## Reporting to the Board

The Committee Chairman provides regular updates to the Board on the key issues discussed at the Committee's meetings.

## Dear Shareholders,

The composition of the Audit Committee changed during the year when, as part of the Board's succession planning strategy, Ian Tyler was appointed as a member of the Board and Audit Committee on Sir Peter Mason's retirement from the Board in May 2013.

Ian is a chartered accountant and until recently served for eight years as Chief Executive of Balfour Beatty plc, an integrated infrastructure services group with operations in over 80 countries. Along with his international operating and financial skills, Ian brings a wealth of experience in long-term contracting, and is well placed to add valuable insight to the Committee's deliberations.

## Financial reporting

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2013 financial statements were:

- **Goodwill:** We considered an analysis of goodwill held on the Group's balance sheet in respect of a number of past major transactions and assumptions made in respect of the relevant cash-generating units to which goodwill has been attributed. The methodology for impairment testing used by the Group is set out in note 11 to the Group accounts on page 146. The Group has incurred a goodwill impairment of £865m relating to the US Intelligence & Security and Land & Armaments businesses as a result of an increase in the Group's post-tax weighted average cost of capital and an estimate of reductions in US defence spending.
- **Pensions:** The Group's retirement benefit obligation is significant (£3.5bn) compared with the Group's net assets (£3.4bn). We challenged the key assumptions supporting the valuation of the retirement benefit obligation. This included a comparison of the discount and inflation rates used against externally derived data. We reviewed the methodology used to allocate a proportion of the retirement benefit obligation to equity accounted investments and other participating employers, and concluded that this was appropriate with reference to agreements between the Company and those companies. We also considered the adequacy of disclosures in respect of the sensitivity of the deficit to changes in these key assumptions.

The principal accounting policy change in 2013 was the adoption of International Accounting Standard 19 relating to Employee Benefits. In particular, we reviewed the impact that it would have on pension

liability disclosures and the resultant requirement to restate earnings per share for 2012 to ensure that a meaningful comparison could be made with 2013 earnings. Further details of the accounting policy change can be found on page 126.

- **Recognition of profit and provisioning:** We reviewed key estimates and judgements prior to publication of the financial statements. Our review included the key estimates and assumptions applied in determining the financial status of the more significant programmes, including Saudi Typhoon aircraft, Radford Army Ammunition Plant and Queen Elizabeth Class aircraft carriers.
- **Taxation:** We reviewed the Group's tax strategy as set out on page 120. On a twice-yearly basis, we reviewed the Group's tax charge and tax provisions.

The Committee agreed the parameters of, and reviewed a report to support, the going concern statement.

An intrinsic requirement of a group's financial statements is for the report and accounts to be fair, balanced and understandable. The co-ordination and review of the Group-wide input into the Annual Report is a sizeable exercise performed within an exacting timeframe which runs alongside the formal audit process undertaken by the Auditors.

The process to ensure that the Committee, and then the Board, are satisfied with the overall fairness, balance and clarity of the document has been underpinned by:

- comprehensive guidance issued to contributors at operational level;
- a verification process dealing with the factual content of the reports;
- comprehensive reviews undertaken at different levels in the Group that aim to ensure consistency and overall balance; and
- comprehensive review by the directors and the senior team.

#### Internal control and risk management

Effective management of risks and opportunities is essential to the delivery of the Group's strategic objectives, achievement of sustainable shareholder value, protection of its reputation and meeting the requirement of good corporate governance. The way in which the Company manages risk is set out on pages 29 and 30, with the principal risks facing the Group set out on pages 106 to 111.

The Committee has reviewed the ongoing effectiveness of the Company's risk management processes as part of its wider review of the effectiveness of internal controls.

Our review of internal controls has also encompassed a review of the reports relating to the six-monthly Operational Assurance Statements, which are submitted by each business or function as a mandated policy under the Group-wide Operational Framework, and controls reports and audit reports from both internal and external auditors.

A key controls focus for the Committee is the controls environment surrounding Lifecycle Management (LCM), LCM being integral to the successful execution of the Group's projects and programmes, and of particular importance in the early identification of programme risk and the determination of profit recognition or provisioning. We have discussed the outputs of general financial and LCM controls testing, and any required improvement actions, with management, and internal and external audit, with a view to ensuring the ongoing robustness of programme execution and risk mitigation.

#### External audit

Our former KPMG audit engagement partner, Tony Cates, rotated off the BAE Systems' audit account at the conclusion of the 2012 audit having completed his permitted tenure of five years, and was succeeded by Ian Starkey. The latter attended a number of audit closure meetings and Committee meetings prior to the handover to ensure a smooth transition.

Continuity and consistency of audit quality are important, however the Committee is also mindful of ongoing debate about the operation of the audit market, audit tenure and the longevity of audit firm relationships with the companies they audit. KPMG Audit Plc, and their legacy predecessors, have been in place as the Company's Auditors since 1981 without re-tender and it is our present intention to initiate an audit re-tendering process not later than 2017 prior to the rotation of the current audit engagement partner. The Committee will keep this re-tendering timeframe under review and will use our regular reviews of auditor effectiveness to assess whether an earlier date for a re-tender would be desirable. There are no contractual obligations that would restrict the selection of a different auditor.

The Committee's policy is to initiate an annual review of audit effectiveness at the conclusion of each year-end audit and to supplement this with an in-depth review of audit effectiveness on a triennial basis.

Having assessed the output of the annual review undertaken at the close of the 2013 year-end audit, taken account of the Committee's own interactions with KPMG throughout the year, and satisfied itself on the continuing independence of the Auditors, the

#### Auditor independence – Non-Audit Services Policy

The Committee has a formal policy governing the engagement of the Auditors to provide non-audit services which we review on an annual basis. The Policy prohibits certain activities from being undertaken by the Auditors such as book-keeping and work relating to the preparation of accounting records and financial statements that will ultimately be subject to external audit; financial information system design and implementation; internal auditing; and any work where a mutuality of interest is created that could compromise the independence of the Auditors. The Policy also places restrictions on the employment of former employees of the Auditors.

Recognising that the Auditors are best placed to undertake certain work of a non-audit nature, the Policy permits the provision of Audit-Related Services and Permitted Non-Audit Services up to limits that are pre-approved by the Committee, with specific approvals required beyond such limits by the Committee. A copy of the policy is available on the Company's website.

Details of fees payable to the Auditors are set out on page 133. In 2013, non-audit fees represented 24% of the audit fee. The principal non-audit services provided by the Auditors related to tax compliance and advisory services, and the interim review.

Committee proposed to the Board that it recommend that shareholders support the appointment of KPMG at the 2014 Annual General Meeting. The review was based on a Group-wide evaluation at management and functional level, together with input from each of the Audit Committee members. The evaluation covered areas such as understanding of the Group's risks and opportunities to facilitate the development of an appropriate audit plan; the robustness of audit processes; objectivity; the quality of communications; and the ability to provide a seamless service across differing jurisdictions. We provided feedback to the Auditors from the evaluation, discussed areas where enhancements could be made and will assess how these actions have been incorporated into the 2014 audit plan when the latter has been formulated.

We will undertake our triennial review later in 2014 which will encompass management performance evaluation, an independent client service review, future audit strategy and fee benchmarking.

#### Internal Audit

Internal Audit plays an important role in assessing the effectiveness of internal controls by a programme of reviews based on a continuing assessment of business risk across the Group.

The annual internal audit programme is agreed jointly by the Audit and Corporate Responsibility committees to ensure that the over-arching internal audit programme includes the assessment of the effectiveness of policies and processes relating to key areas of ethical and reputational risk, as well as financial risk. The Committee considered the output from the 2013 annual internal audit programme of assurance work on a six-monthly basis.

An External Quality Assessment (EQA) of the Internal Audit function was undertaken in 2013 by PricewaterhouseCoopers LLP (PwC) which considered all key aspects of the function's operation. The review was positive with PwC confirming that the function operated in conformance with the International Standards on Internal Auditing. PwC also commended the Board, Audit Committee and senior executives on the strength of their support for the Internal Audit function. Recommendations to enhance effectiveness further were made and are being addressed through the normal planning process for the Internal Audit function.

**Nick Rose**

Chairman – Audit Committee

#### Other key areas of work undertaken by the Committee in 2013

During the year, the Committee has:

- reviewed and challenged the external audit plan to gauge whether it was appropriately focused;
- considered the accounting, financial control and audit issues reported by the Auditors that flowed from the audit work;
- reviewed the confirmation and information received from KPMG on the arrangements that it has in place to safeguard its independence and objectivity;
- agreed the rotation sequence for key audit partners below the lead audit engagement partner;
- reviewed and agreed the audit fee;
- reviewed and discussed on a quarterly basis the nature and level of non-audit fees, and undertaken an annual review of the Non-Audit Services Policy which we concluded was still appropriate (see page 75);
- reviewed the effectiveness of the Company's helpline procedures in respect of the reporting of possible accounting, financial control or other financial irregularities, and concluded that the procedures continue to work effectively;
- reviewed on a twice-yearly basis the procedures for the identification, assessment and reporting of risk; and
- considered corporate governance and accounting developments.

#### Meetings with business unit management in 2013

The Committee places importance on direct contact with local operational and financial management as these meetings enable us to gain a more in-depth view of the strategic and operational issues pertaining to those businesses, an overview of their controls environment, and a better understanding of their risk management processes.

In 2013, we focused our attention on the Group's Cyber & Intelligence segment, the underlying businesses in which have different risk profiles from those in the Platforms & Services businesses. The Committee met locally with senior management in both the Intelligence & Security business in the US and at Applied Intelligence in the UK. Issues discussed by local management included:

##### Intelligence & Security (US)

- Challenges of growing the business in a market where the impact of Sequestration was unknown; and
- maturity of assurance processes over internal financial controls, including internal audit work.

##### Applied Intelligence (UK)

- Progress on the implementation of an Enterprise Resource Planning (ERP) system to integrate business information management systems;
- maturity of assurance processes over internal financial controls, including internal audit work; and
- enhancements made to the business' reporting processes under the Group's Operational Assurance Statement.

# CORPORATE RESPONSIBILITY COMMITTEE REPORT



**Paul Anderson**  
Chairman of the Corporate  
Responsibility Committee

## Members

Paul Anderson (Chairman)  
Harriet Green  
Ian Tyler

Ian Tyler replaced Sir Peter Mason as a member on 8 May 2013.

## Governance

The Corporate Responsibility Committee was in place throughout 2013, and held five meetings. All its members are independent in accordance with the provisions of the Code.

## Summary of 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 and other non-financial risks
- Monitoring and reviewing the role and effectiveness of the Company's Internal Audit function in relation to corporate responsibility
- Providing oversight of the Company's compliance with corporate responsibility-related policies and procedures
- Reviewing audit and assurance reports produced by the corporate responsibility assurer
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues
- Making proposals to the Remuneration Committee regarding appropriate corporate responsibility-related performance objectives for executive directors
- Reviewing the Company's arrangements for employees to obtain further advice on ethical issues in confidence
- Ensuring that the Code of Conduct is regularly reviewed and reflects best practice for such codes
- Ensuring the Company's Annual Report and Accounts includes an examination of ethical business conduct within the Company

## Dear Shareholders,

It is now over five years since the publication of the Woolf Committee Report. This independent report on ethical business conduct in BAE Systems provided very clear guidance on what was required. Subsequently, the rigour and whole-hearted nature in which the recommendations have been implemented by senior management has provided the Company with robust controls and a culture that leaves no doubt as to what is expected of all employees in terms of their conduct. In 2013, as Lord Gold, the Corporate Monitor appointed by the US Department of Justice, ended his three-year appointment, the Committee spent time with him reflecting on how the Committee can best assure that progress in the area of ethical business conduct will continue into the future. Having taken time to reflect on this, as well as the other responsibilities of the Committee, we agreed the following:

- A rolling three-year programme of activity has been developed for the Committee that ensures that it is able to fulfil all of its responsibilities, including the provision of comprehensive oversight of ethical business conduct based on the priorities and structures identified by Lord Woolf back in 2008, and re-emphasised more recently by Lord Gold.
- As conduct is often driven by organisational culture, this year we will engage an independent third party to undertake a survey of employee opinions across the Group, similar to that undertaken by the Ethical Leadership Group in 2011.
- Training and employee engagement is an important facilitator of the right employee behaviours and we will be meeting with the Group HR Director on a regular basis to develop our understanding of how such activity is being managed across the Group.
- To assist in discharging its responsibilities, the Corporate Responsibility Committee will meet five times a year and one of these meetings will be for a full day and held at one of the Company's sites – providing an opportunity for directors to gain first-hand experience of the application of corporate responsibility-related matters.
- We will benchmark our Code of Conduct and policies and processes regularly to ensure that we remain at the leading edge of managing business conduct.



We also agreed that we will review the reporting of corporate responsibility matters in our Annual Report to ensure that it accurately reflects the importance placed on such matters, not only by the members of the Committee, but the Board as a whole.

In addition to ethical business conduct, the Corporate Responsibility Committee also focuses on safety, diversity and inclusion, and environment. Reporting on these can be found on pages 62 and 63 and also pages 112 to 119.

In respect of safety, as also reported by the Chief Executive, there were two work-related fatalities in 2013. The details of these fatalities and the Company's responses to them were reviewed in detail by the Committee to ensure that lessons were learnt and, where necessary, action was taken.

The Committee uses Recordable Accident Rate and major injuries as its basic measures of performance. In 2013, whilst there was an improvement in the Recordable Accident Rate across the Group, there was an increase in major injuries (as defined by the UK Health and Safety Executive, and includes fractures, injuries to eyes and loss of consciousness). Management is addressing the issues that should drive improvements in safety performance, and will be focused on this during 2014. The targets set by the Committee are designed to be stretching and encourage an approach to safety management that will, over time, deliver performance for the Company that is in line with the best. Parts of the Group are already performing at this level and we see good examples of businesses working together to share learning and adoption of a more integrated approach to developing safety management. However, our approach to safety is more than just targets; the Committee also monitors how safety is managed, looking at how we can embed safer ways of working regarding personal, process and product safety.

Progress is being made in diversity and inclusion with senior management paying a good level of attention to the diversification of our leadership and talent pipelines. We recognise that culture change takes time but to make a difference we need to continue to see the right leadership behaviours and programmes of activities that will drive change, both in absolute numbers and also in employee perceptions of how inclusive a Company we are. The all-employee training on unconscious bias undertaken across the Group in 2013, and aimed at developing an inclusive working environment, is a good example of such an activity. One of the areas that the Committee is focusing on is our human resource programmes and their performance in ensuring that diversity and inclusion goals are progressed. The Group HR Director is asked to attend Committee meetings regularly to report on this matter.

Our approach to environmental matters is to require each of the Company's businesses to target efficiencies for energy, water and waste. Overall, our processes for setting targets and reporting on environmental matters are not as mature as those we see for the other areas that the Committee focuses on. However, we are seeing a good level of engagement from businesses in achieving targets that promote a more environmentally sustainable approach to business and one where cost savings from efficiencies enhance the performance of our businesses.

Finally, one of the most useful and informative activities that the Committee undertakes is to visit different sites across the Company and use these visits to dig a bit deeper into corporate responsibility matters. One such visit in 2013 was to the Submarines business in Barrow-in-Furness where we spent time looking at the management of product safety, nuclear regulation, and health and safety management in a complex industrial environment.

**Paul Anderson**

Chairman – Corporate Responsibility Committee

**Other key areas of work undertaken by the Committee in 2013**

During the year, the Committee has:

- reviewed the Company's performance against the corporate responsibility objectives set for 2012 and made recommendations to the Remuneration Committee to assist it in agreeing the level of award to be made under the annual incentive plan. Made recommendations on corporate responsibility-related metrics for the 2013 annual incentive plan;
- received reports and presentations from the head of Internal Audit on audit work undertaken during the year, particularly with regards to corporate responsibility-related matters;
- reviewed the Company's offset commitments and the controls in place regarding the approval and acceptance of such commitments and their ongoing management;
- considered the outputs from the non-financial risk reviews undertaken by the Executive Committee and the status of associated mitigation activity;
- reviewed the operation and effectiveness of the Company's Ethics Helpline and the nature of matters reported;
- agreed the scope of the work to be undertaken by Deloitte LLP pursuant to their assurance statement included in this Annual Report;
- reviewed the Company's anti-bribery compliance processes, including those for the appointment of advisers;
- met with the Group HR Director, and discussed and reviewed the Company's programme aimed at developing a more diverse and inclusive workforce; and
- reviewed the Company's Product Trading Policy, dealing with the products and services developed and sold by the Company, and ensuring that they reflect the Company's standards of integrity.

# NOMINATIONS COMMITTEE REPORT



**Sir Roger Carr**  
Chairman of the Nominations  
Committee

## Members

Sir Roger Carr (Chairman)  
Paul Anderson  
Nick Rose

Sir Richard Olver was chairman of the Committee throughout 2013 and was succeeded by Sir Roger Carr on 1 February 2014. Sir Peter Mason was a member of the Committee up to 8 May 2013.

## Governance

The Nominations Committee was in place throughout 2013 and held nine meetings. It is chaired by the Chairman of the Company. The Chairman was independent when appointed to the Board and the other two members of the Committee are independent non-executive directors in accordance with the provisions of the Code.

## Summary of responsibilities

- Reviewing regularly the structure, size and composition of the Board, and making recommendations to the Board on any appropriate changes
- Identifying and nominating for the Board's approval suitable candidates to fill any vacancies for non-executive and, with the assistance of the Chief Executive, executive directors
- Planning for the orderly succession of directors to the Board
- Recommending to the Board the membership and chairmanship of the Audit, Corporate Responsibility and Remuneration committees

## Summary of activity

- The search for a suitable candidate to succeed Sir Richard Olver as Chairman of the Board was undertaken by the Committee in 2013. Throughout this process, the Committee was chaired by the Board's Senior Independent Director, Nick Rose. The Committee was assisted in its process by the executive search consultants, Spencer Stuart\*. During the search process, Mr Rose engaged with important stakeholders – including major shareholders – and also consulted with all members of the Board on a regular basis.
- The Committee nominated Sir Roger Carr for appointment and he was duly appointed a non-executive director of the Company with effect from 1 October 2013, and succeeded Sir Richard Olver as Chairman on 1 February 2014. Sir Roger serves as Chairman in a non-executive capacity and was independent at the time of his appointment in accordance with Code provision B.1.1.
- The Committee undertook a search for two non-executive directors during the year. The Committee appointed the executive search consultants, Zygos Partners\*, to assist with this activity. This work resulted in the appointment of Ian Tyler and Chris Grigg with effect from 8 May and 1 July 2013, respectively.
- The Company's executive development and succession planning processes were reviewed by the Committee during 2013.
- Following the announcement that Linda Hudson, President and Chief Executive Officer of the Company's US operations, would be retiring this year, the Committee worked with the Chief Executive and the BAE Systems, Inc. board to identify the right candidate to replace her. As a result of this, Jerry DeMuro, a former senior executive at General Dynamics, was appointed to succeed Ms Hudson as President and Chief Executive Officer of BAE Systems, Inc. and a member of the BAE Systems plc Board with effect from 1 February 2014.

\* Spencer Stuart provide other recruitment services to the Company. The recruitment services that Zygos Partners provided directly to the Chairman and Nominations Committee in respect of non-executive recruitment were the only services they provided to the Company during the year. Both firms are signatories to the Voluntary Code of Conduct for Executive Recruitment Firms (as recommended by the Davies Report).

# REMUNERATION COMMITTEE REPORT



**Carl Symon**  
Chairman of the  
Remuneration Committee

## Members

Carl Symon (Chairman)  
Chris Grigg  
Nick Rose

## Governance

The Remuneration Committee was in place throughout 2013 and held eight meetings. Chris Grigg joined the Committee on 1 July 2013 and Lee McIntire served on the Committee until he stepped down from the Board on 20 August 2013. All its members are independent in accordance with the provisions of the Code.

The Chief Executive and 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.

## Summary of 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

**“WE BELIEVE THAT IT IS OF THE  
UTMOST IMPORTANCE TO ENSURE  
A STRONG LINK BETWEEN ACTUAL  
REMUNERATION RECEIVED AND THE  
ACHIEVEMENT OF OUR STRATEGIC  
AND BUSINESS OBJECTIVES.”**

## Dear Shareholders,

On behalf of the Board, I am pleased to present the Remuneration Committee's report for 2013, for which we will be seeking shareholders' approval at the 2014 AGM.

Since I last reported to you on the work undertaken by the Remuneration Committee, there has been a good deal of change in the regulations concerning directors' remuneration. The changes were preceded by a wide-ranging debate, which engaged many stakeholders and considered important issues, including the impact that executive incentives can have on the creation of sustainable long-term value for shareholders and the wider economy, the balance of risk and reward between shareholders and executives and, closer to home, the effectiveness of remuneration committees. All members of the Remuneration Committee have followed this debate and the evolution of the new regulations closely. We are therefore keenly aware of the important governance role that the Committee plays and the regulatory and governance requirements to which we are required to adhere.

The remuneration policy that we have set out in this report is the result of a detailed review that began with a broad discussion and analysis of what we wished to achieve and the various remuneration structures that could be employed. The views of our shareholders informed us throughout our deliberations and the views of our major shareholders were sought directly once the policy had taken shape. Ultimately, the work of the Remuneration Committee is informed by the wider role we have as non-executive directors in understanding and overseeing the performance of the Company, including the markets in which it operates and the strategy agreed by the Board.

## BAE Systems' remuneration philosophy

The Committee's overall approach remains unchanged: we aim to recognise the challenging business environment in which we operate, whilst fostering a Total Performance culture at all levels of the Group. Our remuneration strategy provides incentives for executives to deliver on the Company goals and rewards them for the achievement of the Group's strategy through a combination of short-term incentives targeted at Group, business segment and personal performance as well as leadership behaviours, and long-term incentives which are targeted at Group performance. We ensure that executive pay is aligned with Company results and that the interests of our executives are strongly aligned to those of our shareholders by delivering long-term reward in shares. Our aim is to provide a total remuneration package that

is fair and transparent and which balances overall commonality of design with appropriate tailoring to ensure competitiveness in our different principal markets.

#### Context to the Committee's decisions

Our remuneration strategy is to ensure we are able to attract, retain and reward the key talent we need to realise the Company's strategic objectives, deliver on customer commitments, lead and inspire employees and to drive value for our shareholders. It recognises the need to be competitive in those markets in which we operate and compete for talent. A core design objective is an appropriate balance of short-term and long-term incentives, focused on Group performance, business segment performance and leadership behaviours that underpin a Total Performance culture.

The focus of changes to our reward framework in recent years has been to improve alignment with shareholder value creation and address the perceived complexity of our long-term incentive arrangements by simplifying our arrangements. The Committee believes that the introduction of share options in 2012 (without increasing the expected value of the overall package) has created a direct relationship with absolute share price performance and a clear line of sight for executives. And with approval at the AGM in May 2013, we simplified our framework by eliminating our Share Matching Plan (SMP) which was regarded as overly complex. The pay-out experience under our incentive plans provides confidence that the choice and weighting of the performance metrics in our incentive plans are appropriately rewarding our executive team only when their performance delivers tangible business results in line with the Group's strategy. Against this background, the Committee has continued to consider whether more can be done to reduce complexity and provide even greater clarity and transparency for shareholders.

In 2013, our performance against annual incentive targets was as follows: Our adjusted underlying earnings per share (EPS) of 42.1p was between threshold and target, driven predominantly by the impacts of Sequestration on the performance of BAE Systems, Inc. and the contract losses in our US Support Solutions business. Order intake was in line with target and the performance for both year-end and average net debt was between target and stretch. The reported diluted underlying EPS of 41.8p was below the level required for any vesting against the EPS metric applicable to any long-term incentives awarded in 2011. This result of 41.8p will form the baseline figures against which the

EPS performance metric for 2014 Performance Share Plan (PSP) awards will be assessed.

#### Key Committee decisions

During 2013, the Committee continued to focus on tackling complexity and ensuring alignment with key drivers of business performance. Key decisions made by the Committee during the year were:

- The salaries of the Chief Executive and the Group Finance Director remain unchanged in 2014. For the second successive year, there will be no increase in base compensation and no increase in earnings opportunity flowing through to the rest of the package. The President and Chief Executive Officer of BAE Systems, Inc. has been newly appointed effective 1 February 2014 and the detail of his remuneration package is set out in the Annual remuneration report.
- Annual bonus pay-outs for the executive directors under the annual incentive plan ranged from 48.9% to 54.6% of maximum.
- EPS performance over the three-year period for awards made in 2011 under the long-term incentive plans was below the minimum 5% per annum average growth requirement. Consequently:
  - the SMP award granted in 2011 earned a nil match; and
  - of the 50% of the awards of shares granted in May 2011 under the EPS portion of the PSP, none will vest. The performance outcome against the Total Shareholder Return (TSR) condition which applies to the other 50% of PSP awards granted in May 2011 cannot be tested until after the date of publication of this report.
- Whilst the Committee considers the award of performance shares, share options and restricted stock as essential to provide incentives and reward executives appropriately and ensure competitiveness of design in our different major markets, we are proposing the introduction of a single umbrella plan. If this is approved by shareholders at the 2014 AGM, it will replace the three current separate long-term incentive plans with a single long-term incentive framework with flexibility of delivery vehicles such that Long-Term Incentive (LTI) awards may be granted using a mix of performance shares, share options and restricted stock, underpinned by a common set of rules and terms relating to eligibility and participation, treatment on leaving, change of control and exercise of discretions by the Committee – which in turn will be clearer for shareholders when considering our remuneration policy.

In implementing this umbrella plan, there is no intention to change how the total LTI quantum is determined, how the various LTI elements are used by geography or the underlying design or operation of the different types of equity award. The current LTI opportunity applicable to each of the executive directors remains unchanged.

Subject to formal shareholder approval of the new umbrella plan at the AGM in May 2014, the Committee intends to make awards under this new plan for the first time in Spring 2015. LTI awards in 2014 will continue to be delivered under the current incentive framework and plan rules previously approved by shareholders.

- In the case of the President and Chief Executive Officer of BAE Systems, Inc., 50% of the PSP has previously been based on a measure relating to operating cash performance of the US businesses (with the other 50% being subject to the same EPS performance condition as applies to other executive directors). In order to create stronger alignment of focus and reward outcomes across the entire executive leadership team, awards of performance shares will be based 50% on EPS growth and 50% on relative TSR for all executive directors, irrespective of geography.
- The Remuneration Committee has maintained the EPS performance conditions for PSP awards in 2014 at a challenging growth target of 5% to 11% per annum.
- We are retaining our requirement for executive directors to build up a meaningful personal shareholding, which was increased in 2013 for the Chief Executive from 200% to 300% of salary and now stands at 350% for the President and Chief Executive Officer of BAE Systems, Inc. and at 200% for the Group Finance Director.

We intend in practice to operate the Directors' remuneration policy from the 2014 AGM. For the purposes of the Companies Act 2006, the legally binding restrictions under such policy will only take legal effect from 1 January 2015 subject to shareholder approval.

On behalf of the Board

**Carl Symon**

Chairman – Remuneration Committee



# DIRECTORS' REMUNERATION POLICY

It is intended in practice to operate the Directors' remuneration policy ('the Policy') from the 2014 AGM. For the purposes of the Companies Act 2006, the Policy will only take legal effect on 1 January 2015 subject to shareholder approval at the 2014 AGM.

The Policy will be displayed in the 'Investors' section of the Company's website, immediately after the 2014 AGM.

The Committee considers remuneration policy annually to ensure that it remains aligned with business needs and is appropriately positioned relative to the market. However,

in the absence of exceptional or unexpected circumstances which may necessitate a change to the Policy, there is currently no intention to revise the Policy more frequently than every three years. We use target performance to estimate the total potential reward and benchmark it against reward packages paid by BAE Systems' competitors.

Our Policy is to set base salary with reference to the relevant market-competitive level. Actual total direct reward reflects the performance of the individual and the Company as a whole. The aim is to deliver an overall remuneration package for executive

directors which provides an appropriate balance between short-term and long-term reward and between fixed and variable reward as described in the table below.

Whilst our long-term incentive plans provide the Committee with discretion in respect of vesting outcomes that affect the actual level of reward payable to individuals, such discretion would only be used in exceptional circumstances and, if exercised, disclosed at the latest in the report on implementation of the remuneration policy (i.e. the Annual remuneration report) for the year in question.

## Executive directors' policy table

Element	Purpose and link to strategy	
Base salary	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.	
Operation	Maximum opportunity	Performance metrics used, weighting and time period applicable
Salaries are reviewed annually. Business and individual performance, skills, the scope of the role and the individual's time in the role are taken into account when assessing salaries, as is market data for similar roles in the relevant market comparator group.	When considering salary increases for the executive directors in their current roles, the Committee considers the general level of salary increase across the Group and in the relevant external market.	None.
The comparator group for UK executive directors is comprised of selected companies from the top 70 of the FTSE 100 and is constructed to position BAE Systems around the median in terms of market capitalisation. For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group is drawn from companies in the US aerospace and defence sectors, together with similar organisations in the general industry sector where BAE Systems, Inc. is positioned at the median of the comparator group by reference to revenue size.	Actual increases for the executive directors in their current roles will generally not exceed the average percentage increase for employees as a whole, taking account of the level of movement within the relevant UK/US comparator group.	
	As a maximum, in exceptional circumstances (such as a material increase in job size or complexity, or a recently appointed executive director where the salary is positioned low against the market), the increase will not exceed 10% in any single year.	

Executive directors' policy table *continued*

Element	Purpose and link to strategy				
Annual incentive	<p>Drive and reward annual performance of individuals and teams on both financial and non-financial metrics, including leadership behaviours in order to deliver sustainable growth in shareholder value.</p> <p>Compulsory deferral into shares increases alignment with shareholder interests.</p>				
Operation	<table> <tr> <th data-bbox="676 685 852 707">Maximum opportunity</th><th data-bbox="1158 663 1498 707">Performance metrics used, weighting and time period applicable</th></tr> <tr> <td data-bbox="676 714 1134 976"> <p>Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary</p> <p>Group Finance Director: 160% of salary</p> <p>The pay-out for maximum performance is 200% of on-target. The pay-out for achieving a threshold performance is 40% of the target, with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.</p> </td><td data-bbox="1158 714 1498 1469"> <p>Metrics and weightings applicable in 2014:</p> <p>Group earnings per share (EPS) – 40%</p> <p>Group cash – 25%</p> <p>Order intake – 15%</p> <p>Safety – 5%</p> <p>Personal objectives – 15%</p> <p>Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year. The measures include financial and non-financial metrics as well as the achievement of personal objectives. Measures will be weighted each year according to business priorities.</p> <p>See notes 4 and 5 on page 87 regarding the selection and weighting of performance metrics.</p> <p>Notwithstanding performance against the above metrics, all bonus payments are at the discretion of the Remuneration Committee, which will be based on an assessment of the individual's personal contribution to business performance over the relevant year and leadership behaviours demonstrated in making that contribution, relative to others.</p> </td></tr> </table>	Maximum opportunity	Performance metrics used, weighting and time period applicable	<p>Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary</p> <p>Group Finance Director: 160% of salary</p> <p>The pay-out for maximum performance is 200% of on-target. The pay-out for achieving a threshold performance is 40% of the target, with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.</p>	<p>Metrics and weightings applicable in 2014:</p> <p>Group earnings per share (EPS) – 40%</p> <p>Group cash – 25%</p> <p>Order intake – 15%</p> <p>Safety – 5%</p> <p>Personal objectives – 15%</p> <p>Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year. The measures include financial and non-financial metrics as well as the achievement of personal objectives. Measures will be weighted each year according to business priorities.</p> <p>See notes 4 and 5 on page 87 regarding the selection and weighting of performance metrics.</p> <p>Notwithstanding performance against the above metrics, all bonus payments are at the discretion of the Remuneration Committee, which will be based on an assessment of the individual's personal contribution to business performance over the relevant year and leadership behaviours demonstrated in making that contribution, relative to others.</p>
Maximum opportunity	Performance metrics used, weighting and time period applicable				
<p>Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary</p> <p>Group Finance Director: 160% of salary</p> <p>The pay-out for maximum performance is 200% of on-target. The pay-out for achieving a threshold performance is 40% of the target, with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.</p>	<p>Metrics and weightings applicable in 2014:</p> <p>Group earnings per share (EPS) – 40%</p> <p>Group cash – 25%</p> <p>Order intake – 15%</p> <p>Safety – 5%</p> <p>Personal objectives – 15%</p> <p>Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year. The measures include financial and non-financial metrics as well as the achievement of personal objectives. Measures will be weighted each year according to business priorities.</p> <p>See notes 4 and 5 on page 87 regarding the selection and weighting of performance metrics.</p> <p>Notwithstanding performance against the above metrics, all bonus payments are at the discretion of the Remuneration Committee, which will be based on an assessment of the individual's personal contribution to business performance over the relevant year and leadership behaviours demonstrated in making that contribution, relative to others.</p>				

Executive directors' policy table *continued*

Element	Long-Term Incentives (LTI)	Operation	Maximum opportunity	Performance metrics used, weighting and time period applicable
		<p>All awards are granted based on a percentage of salary and share price at the date of grant.</p> <p>Dividend equivalents in respect of vested shares are paid at the time of vesting and are not taken into account when determining individual limits.</p> <p>Pre-vesting clawback provisions apply to all awards and 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.</p> <p>The Committee will establish the targets for each measure at the start of each performance period based on Group projections and market expectations for the business. The performance conditions for previous awards are described in the Annual remuneration report.</p> <p>Awards and performance conditions can be adjusted to take account of variations of share capital and other transactions or events.</p> <p>On a change of control or similar transaction, awards generally will vest to the extent performance conditions are then satisfied (if applicable) and then be pro-rated to reflect the acceleration of vesting unless the Committee decides otherwise. Alternatively, awards may be exchanged for equivalent awards over shares in the acquiring company.</p> <p>The share plan rules may be amended from time-to-time by the Committee in certain circumstances including minor changes for administrative, tax or other regulatory purposes.</p> <p>Subject to this Policy, performance conditions may be amended in other circumstances if the Committee considers it appropriate.</p>		<p>See notes 4 and 5 on page 87 regarding the selection and weighting of performance metrics.</p>
Operation		<p>It is proposed to consolidate the three long-term incentive plans described below into a single umbrella plan with effect from 1 January 2015, subject to shareholder approval at the 2014 AGM.</p>	<p>Subject to shareholder approval of the proposed umbrella plan at the 2014 AGM, over the lifetime of this remuneration policy, the Committee will have discretion to vary the weighting and mix of different types of awards within the following limits:</p> <p><b>(a) Performance Shares:</b> UK executive directors: Between 50% and 75% of overall LTI Expected Value (EV)</p> <p>US executive directors: Between 25% and 50% of overall LTI EV</p> <p><b>(b) Share Options:</b> Between 25% and 50% of overall LTI EV</p> <p><b>(c) Restricted Shares:</b> Applicable to US executive directors only. No more than one-third of overall LTI EV</p> <p>The maximum opportunity in respect of each element is as set out below.</p>	<p>Performance metrics used, weighting and time period applicable</p> <p>See below in relation to Performance Shares and Share Options.</p> <p>See notes 4 and 5 on page 87.</p>

Executive directors' policy table *continued*

Element	Purpose and link to strategy				
<b>Long-Term Incentives</b> <i>continued</i> Performance Shares	Drive and reward delivery of sustained long-term EPS and Total Shareholder Return (TSR) performance aligned to the interests of shareholders.				
<b>Operation</b> Awards, typically in the form of nil-cost options, vest and become exercisable in three tranches on the third, fourth and fifth anniversary of grant, subject to performance conditions. For US participants, awards are delivered as conditional share awards (RSUs) which vest automatically on the third, fourth and fifth anniversary of grant, subject to performance conditions.	<table> <tr> <th data-bbox="676 624 1134 647">Maximum opportunity</th><th data-bbox="1160 604 1492 647">Performance metrics used, weighting and time period applicable</th></tr> <tr> <td data-bbox="676 654 1134 775">           Chief Executive: 250% of salary            Group Finance Director: 215% of salary            President and Chief Executive Officer of BAE Systems, Inc.: 242% of salary         </td><td data-bbox="1160 654 1492 1413">           Metrics and weightings applicable to 2014 awards:            50% of award based on TSR growth relative to a comparator group of at least 12 companies over the three-year performance period.            Nil vesting if TSR ranked below median in the peer group; 25% exercisable if TSR ranked at the median; 100% exercisable if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile. Award subject to a secondary financial measure as set out on page 100.            50% of award based on average annual EPS growth over the three years with nil vesting at average annual EPS growth of 5% and 100% vesting at 11% growth.            Pro-rata vesting for intermediate performance.            50% of awards made in 2012 and 2013 for US participants were based on long-term operating cash performance measured at the level of the US businesses in place of TSR growth.            See notes 4 and 5 on page 87.         </td></tr> </table>	Maximum opportunity	Performance metrics used, weighting and time period applicable	Chief Executive: 250% of salary Group Finance Director: 215% of salary President and Chief Executive Officer of BAE Systems, Inc.: 242% of salary	Metrics and weightings applicable to 2014 awards: 50% of award based on TSR growth relative to a comparator group of at least 12 companies over the three-year performance period. Nil vesting if TSR ranked below median in the peer group; 25% exercisable if TSR ranked at the median; 100% exercisable if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile. Award subject to a secondary financial measure as set out on page 100. 50% of award based on average annual EPS growth over the three years with nil vesting at average annual EPS growth of 5% and 100% vesting at 11% growth. Pro-rata vesting for intermediate performance. 50% of awards made in 2012 and 2013 for US participants were based on long-term operating cash performance measured at the level of the US businesses in place of TSR growth. See notes 4 and 5 on page 87.
Maximum opportunity	Performance metrics used, weighting and time period applicable				
Chief Executive: 250% of salary Group Finance Director: 215% of salary President and Chief Executive Officer of BAE Systems, Inc.: 242% of salary	Metrics and weightings applicable to 2014 awards: 50% of award based on TSR growth relative to a comparator group of at least 12 companies over the three-year performance period. Nil vesting if TSR ranked below median in the peer group; 25% exercisable if TSR ranked at the median; 100% exercisable if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile. Award subject to a secondary financial measure as set out on page 100. 50% of award based on average annual EPS growth over the three years with nil vesting at average annual EPS growth of 5% and 100% vesting at 11% growth. Pro-rata vesting for intermediate performance. 50% of awards made in 2012 and 2013 for US participants were based on long-term operating cash performance measured at the level of the US businesses in place of TSR growth. See notes 4 and 5 on page 87.				
Element	Purpose and link to strategy				
<b>Long-Term Incentives</b> <i>continued</i> Share Options	Drive and reward delivery of TSR performance and sustained improvement in the Company's share price.				
<b>Operation</b> Subject to a TSR performance condition. Market value options are normally exercisable between the third and tenth anniversary of their grant.	<table> <tr> <th data-bbox="676 1576 1134 1599">Maximum opportunity</th><th data-bbox="1160 1556 1492 1599">Performance metrics used, weighting and time period applicable</th></tr> <tr> <td data-bbox="676 1606 1134 1724">           Chief Executive: 300% of salary            Group Finance Director: 300% of salary            President and Chief Executive Officer of BAE Systems, Inc.: 390% of salary         </td><td data-bbox="1160 1606 1492 1738">           For share option awards made to the executive directors only, exercise is subject to a TSR performance condition as set out above.            See notes 4 and 5 on page 87.         </td></tr> </table>	Maximum opportunity	Performance metrics used, weighting and time period applicable	Chief Executive: 300% of salary Group Finance Director: 300% of salary President and Chief Executive Officer of BAE Systems, Inc.: 390% of salary	For share option awards made to the executive directors only, exercise is subject to a TSR performance condition as set out above. See notes 4 and 5 on page 87.
Maximum opportunity	Performance metrics used, weighting and time period applicable				
Chief Executive: 300% of salary Group Finance Director: 300% of salary President and Chief Executive Officer of BAE Systems, Inc.: 390% of salary	For share option awards made to the executive directors only, exercise is subject to a TSR performance condition as set out above. See notes 4 and 5 on page 87.				
Element	Purpose and link to strategy				
<b>Long-Term Incentives</b> <i>continued</i> Restricted Shares	Provide long-term reward through time-vesting awards principally in the Company's US market.				
<b>Operation</b> The shares are subject only to the condition that the participant remains employed by the Group on the vesting date (three years after the award date). These awards are not subject to a performance condition as it is designed to address retention issues principally in the US.	<table> <tr> <th data-bbox="676 1901 1134 1924">Maximum opportunity</th><th data-bbox="1160 1881 1492 1924">Performance metrics used, weighting and time period applicable</th></tr> <tr> <td data-bbox="676 1930 1134 2033">           Chief Executive and Group Finance Director: Not eligible            President and Chief Executive Officer of BAE Systems, Inc.: 100% of salary         </td><td data-bbox="1160 1930 1492 1986">           None.            See notes 4 and 5 on page 87.         </td></tr> </table>	Maximum opportunity	Performance metrics used, weighting and time period applicable	Chief Executive and Group Finance Director: Not eligible President and Chief Executive Officer of BAE Systems, Inc.: 100% of salary	None. See notes 4 and 5 on page 87.
Maximum opportunity	Performance metrics used, weighting and time period applicable				
Chief Executive and Group Finance Director: Not eligible President and Chief Executive Officer of BAE Systems, Inc.: 100% of salary	None. See notes 4 and 5 on page 87.				



Executive directors' policy table *continued*

Element	Purpose and link to strategy
<b>Benefits</b>	Provide employment benefits which ensure that the overall package is market competitive when these elements are taken into account.
<p><b>Operation</b></p> <p>Benefits include provision of a company car (or cash equivalent), life assurance and ill-health benefit cover which are provided directly or through membership of the Company's pension schemes.</p> <p>Opportunity for UK executive directors to participate in the Share Incentive Plan, a tax approved all-employee plan.</p> <p>Additional benefits such as relocation assistance may also be provided in certain circumstances if considered reasonable and appropriate by the Committee.</p>	<p><b>Maximum opportunity</b></p> <p>Benefits are set at a level which the Remuneration Committee considers to be appropriate against comparable roles in companies of similar size in the relevant market.</p> <p>Relocation assistance comprises reimbursement for direct items of expenditure, such as legal, estate agency, removals and temporary accommodation, based on actual costs incurred which are linked to the size and value of the property, plus a maximum relocation allowance of £2,500.</p> <p>Benefits are as reported and itemised within the single total figure shown as part of the Annual remuneration report on page 93. The main benefits in the UK include a car allowance (£16,000 per annum) and private use of a chauffeur-driven car, plus life assurance and ill-health benefit cover provided through membership of the Company's pension schemes. In the US, the benefits include a cash allowance for car and parking (\$20,900 per annum) and private use of a chauffeur-driven car, medical and dental benefits, and insured life and disability benefits. The maximum cost of such benefits will reflect the associated market-competitive cost of provision.</p> <p>Participation limits for the Share Incentive Plan are those set by the UK tax authorities from time-to-time.</p> <p><b>Performance metrics used, weighting and time period applicable</b></p> <p>None.</p>
Element	Purpose and link to strategy
<b>Pension</b>	Provide competitive post-retirement benefits or cash allowance equivalent.
<p><b>Operation</b></p> <p>For any new externally appointed executive directors in the UK, membership of the Company's executive defined contribution plan is offered with Company contributions set as a percentage of base salary. Individuals may elect to receive some or all of their pension contribution as a cash allowance.</p> <p>Current UK executive directors are members of the BAE Systems Executive Pension Scheme and members of the underlying employee pension plan, which provide a target benefit for executive directors payable at normal retirement age (62) of 1/30th of final pensionable earnings (FPE) for each year of service up to a maximum of two-thirds of FPE. Member contributions are currently 8%. Further detail is provided on page 96 as part of the Annual remuneration report.</p> <p>Any new externally appointed US executive directors would be offered membership of the US defined contribution plan.</p>	<p><b>Maximum opportunity</b></p> <p>Company contribution of 19% (in addition to employee contribution of 6%) of base salary only.</p> <p>Under the existing defined benefit scheme, a maximum of two-thirds of FPE accrued at 1/30th for each year of service.</p> <p>The US defined contribution plan provides 100% company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits.</p> <p><b>Performance metrics used, weighting and time period applicable</b></p>

Executive directors' policy table *continued*

Element		
Pension <i>continued</i>		
Operation	Maximum opportunity	Performance metrics used, weighting and time period applicable
Where executive directors' pension entitlement or accrual is restricted to the Lifetime Allowance and/or the Annual Allowance under the relevant pension scheme the Company may offer an unfunded pension promise to offset the impact of these restrictions.	The difference between the value of the registered pension scheme benefits as restricted to the Lifetime Allowance and Annual Allowance and the full value of those registered pension scheme benefits that would be payable if there were no Annual Allowance or Lifetime Allowance restrictions.	

## Notes to the executive directors' policy table

**Remuneration policy for other employees**

- The Company's approach to annual salary reviews is consistent across the Group, with consideration given to the scope of the role, level of experience, performance and market data for similar roles in other companies.
- All leaders may participate in an annual bonus scheme with similar metrics to those used for the executive directors. Other employees may participate in performance-based incentive plans which vary by organisational level and with relevant metrics for the particular area of the business.
- Long-Term Incentive grants may be made to the most senior managers in the business (approximately 250 individuals globally). The nature of the awards depends on the individuals' location, roles and responsibilities, in particular:
  - performance measures and targets for performance share grants are made in line with those applying to executive directors;
  - there are no performance conditions attached to share option grants below executive director level; and
  - Restricted Share grants are currently made to the most senior managers in the US reflecting competitive market practice.

**Performance measures and targets**

- The Committee selected the performance conditions because these are central to the Company's overall strategy and are the key metrics used by the executive directors to oversee the operation of the business. The non-financial performance targets are determined by the Committee in consultation with the Corporate Responsibility Committee.
- The performance measures and targets are determined annually by the Committee, taking account of the Group's strategic objectives, the internal business plan and budgets, as well as external market expectations and general economic conditions. The Committee is of the view that the performance targets for the annual bonus are commercially sensitive and that it would be detrimental to the interests of the Company to disclose them before the start of the financial year. The targets will be disclosed retrospectively after the end of the relevant financial year.

**Minimum Shareholding Requirement (MSR)**

- The Committee has agreed a policy whereby the executive directors are required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and other Long-Term Incentive schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

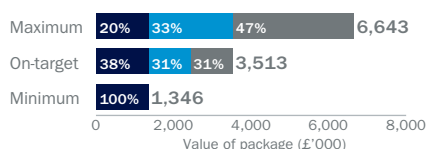
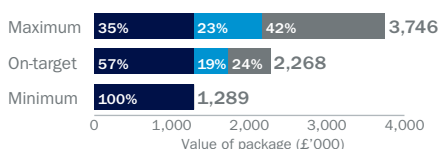
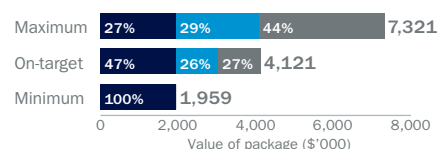
The following table sets out MSR Initial Value and Subsequent Value:

	Initial Value	Subsequent Value
Chief Executive	150%	300%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	175%	350%

**Illustration of application of remuneration policy**

The following charts show the value of the package each of the executive directors would receive based on 2014 base salaries, remuneration and 2014 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 93); pay receivable assuming on-target performance is met; and maximum pay assuming variable elements pay out in full. The scenarios below exclude any share price appreciation and dividends.

UK legislation requires that these charts are given in relation to the first year in which the remuneration policy takes legal effect. Rather than providing further charts for assumed 2015 remuneration and awards, we invite shareholders to assume similar levels for 2015 and we will report on actual levels in 2015.

**Chief Executive (£'000)****Group Finance Director (£'000)****President and Chief Executive Officer of BAE Systems, Inc. (\$'000)**

■ Fixed elements of remuneration ■ Annual bonus ■ PSP and Share options

**Non-executive directors (NEDs) policy table**

Element	Purpose and link to strategy	
<b>Fees</b>	To attract NEDs who have a broad range of experience and skills to provide independent judgement on issues of strategy, performance, resources and standards of conduct.	
<b>Operation</b>	<p><b>Maximum opportunity</b></p> <p>Actual fee levels are disclosed in the Annual remuneration report for the relevant financial year.</p> <p>The current Chairman's fee has been set at £650,000 and fixed at this level for three years from the date of appointment (1 February 2014).</p> <p>The aggregate cost of fees and benefits paid to NEDs (including the Chairman) will not exceed an annual limit of £2.5m.</p>	<p><b>Performance metrics used, weighting and time period applicable</b></p> <p>None.</p>
NEDs fees are set by the Non-Executive Directors' Fees Committee.		
NEDs receive a basic fee with an additional fee for those who are chairmen of committees and/or undertake the role of Senior Independent Director.		
NEDs also receive a travel allowance per meeting on each occasion that a scheduled 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.		
Fees are typically reviewed annually, taking into account time commitment requirements and responsibility of the individual roles, and after reviewing practice in other comparable companies.		
The Chairman's fees are set by the Remuneration Committee on a three-year basis and not normally subject to review during that period.		
Element	Purpose and link to strategy	
<b>Benefits</b>	Reimbursement for reasonable and documented expenses incurred in the performance of duties.	
<b>Operation</b>	<p><b>Maximum opportunity</b></p> <p>See the aggregate limit under 'Fees' above.</p>	<p><b>Performance metrics used, weighting and time period applicable</b></p>
NEDs are not eligible to participate in any pension benefits provided by the Company, nor do they participate in any performance-related incentives.		
The Chairman is provided with a chauffeur-driven car. This may be used for non-Company business, but the cost of the benefit of such usage shall be paid by the Chairman.		
Reimbursement of travel and subsistence costs (including payment of the associated tax cost) incurred by the director or his/her spouse whilst undertaking duties on behalf of the Company that may be assessed as a benefit for tax purposes.		

### Prior commitments

The Company will honour any commitments made in respect of executive director and non-executive director remuneration before the date on which either: (i) the Directors' remuneration policy becomes effective or (ii) an individual becomes a director, even where such commitments are not consistent with the policy prevailing at the time any such commitment is fulfilled. This includes (without limitation) all existing share awards as detailed on page 102 under the PSP, SMP, RSP, ExSOP and ExSOP<sup>2012</sup>, Linda Hudson's leaving arrangements as detailed on page 98 and Peter Lynas' second residence allowance as detailed on page 93.

### Approach to recruitment remuneration

The recruitment policy provides an appropriate framework within which to attract individuals of the required calibre to lead a company of BAE Systems' size, scale and complexity. The Remuneration Committee determines the remuneration package for any appointment to an executive director position, either from within or outside BAE Systems.

<b>Operation</b>	<p>The Remuneration Committee will take into consideration all relevant factors, including overall total remuneration, the type of remuneration being offered and the jurisdiction from which the candidate was recruited, and will operate in order to ensure that arrangements are in the best interests of the Company and its shareholders without paying more than is necessary to secure the individual of the required calibre.</p> <p>The fees and benefits applicable to the appointment of any new non-executive directors will be in accordance with the policy table on page 88.</p>
<b>Opportunity</b>	<p>The Committee seeks to align the remuneration package offered with the policy set out in the executive directors' policy table above recognising that participation under the policy above varies by geography.</p> <ul style="list-style-type: none"> <li>For UK and other non-US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this policy will not exceed 550% of annual salary.</li> <li>For US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this policy will not exceed 750% of annual salary.</li> </ul> <p>The Committee may make awards on hiring an external candidate to 'buy-out' existing equity or, in exceptional circumstances, other elements of remuneration forfeited on leaving the previous employer. In doing so, the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares) and the time over which they would have vested. Buy-out awards would be capped to be no higher, on recruitment, than the fair value of those forfeited. Full details will be disclosed in the next Annual remuneration report following recruitment which will include details of the need to grant a buy-out award.</p>
<b>Fixed elements (base salary, retirement and other benefits)</b>	<p>The salary level will be set in accordance with the policy described in the executive directors' policy table above.</p> <p>The executive director shall be eligible to participate in applicable BAE Systems' employee benefit plans, including coverage under applicable executive and employee pension and benefit programmes in accordance with the terms and conditions of such plans, as may be amended by the Company in its sole discretion from time to time.</p> <p>In the case of promotion of an existing Group employee to an executive directorship on the Board, commitments made before such promotion will continue to be honoured whether or not they are consistent with the remainder of this policy.</p>
<b>Annual Incentive Plan</b>	<p>The appointed executive director will be eligible to earn a discretionary annual bonus in accordance with the Annual Incentive framework as described in the executive directors' policy table above.</p> <p>The level of opportunity will be consistent with the policy disclosed in the executive directors' policy table in this report and subject to the maximums referred to therein.</p>
<b>Long-Term Incentive Plans</b>	<p>The executive director will be eligible for equity awards in such amounts as the Committee may determine in its sole discretion, subject to this policy and the rules of the Long-Term Incentive Plans.</p> <p>The level of opportunity will be consistent with the policy set out in the executive directors' policy table above and subject to the maximums referred to therein.</p>
<b>Other</b>	<p>For internal and external appointments, the Committee may agree that the Company will meet certain relocation expenses in accordance with the provisions described under the Benefits section of the policy table on page 86.</p>



**Service contracts****Executive directors**

<b>Operation</b>	In accordance with long-established policy, all executive directors have rolling service agreements which may be terminated in accordance with the terms of these agreements.		
	<b>Dates of appointment for executive directors</b>		
	Name	Date of appointment	Notice period
	Ian King	27 June 2008	12 months either party
	Peter Lynas	1 April 2011	12 months either party
	Jerry DeMuro	1 February 2014	90 days either party <sup>1</sup>
<b>Notice period</b>	The Committee's policy is that the service contracts of executive directors will not exceed 12 months. In exceptional circumstances, in relation to newly recruiting an executive director operating in a US environment, the notice period may be extended to a maximum of 24 months and structured such that it automatically reduces to 12 months at the end of the first complete year of service.		
<b>Change of control</b>	No executive director has provisions in his service contract that relate to a change of control of the Company.		

<sup>1</sup> Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal.

**Chairman**

The Chairman's appointment is documented in a letter of appointment 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 appointment is for a term of three years from 1 February 2014 unless terminated earlier in accordance with the Company's Articles of Association or by the Company or the Chairman giving not less than six months' notice. The Chairman's appointment is to be reviewed by the Nominations Committee prior to the end of the three-year term and the Chairman may be invited to serve for an additional period.

**Non-executive directors**

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 are shown below:

Name	Date of appointment	Expiry of current three-year term
Paul Anderson	08.10.2009	07.10.2015
Harriet Green	01.11.2010	30.06.2014
Chris Grigg	01.07.2013	30.06.2016
Paula Rosput Reynolds	01.04.2011	30.06.2014
Nick Rose	08.02.2010	07.02.2016
Carl Symon	11.06.2008	10.06.2014
Ian Tyler	08.05.2013	07.05.2016

The non-executive directors are normally appointed for an initial three-year term that, subject to review, may be extended subsequently for further such terms. Any third term of three years is subject to rigorous review, 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.

In accordance with the UK Corporate Governance Code, all directors are subject to annual election or re-election at the Company's AGM.

**Policy on payment for loss of office**

<b>Operation</b>	The policy on payment for loss of office provides a clear set of principles that govern the payments that will be made for loss of office, and take account of the need to ensure a smooth transition for leadership roles during times of change. The policy that will apply for a specific executive director's payment for loss of office will be the policy that was in place at the point when the payment for loss of office was agreed for the executive director in question.
<b>Notice and pay in lieu of notice</b>	<p>Executive directors' contracts allow for termination with contractual notice from either party or termination by way of payment in lieu of notice, at the Company's discretion. Neither notice nor a payment in lieu of notice will be given in the event of gross misconduct. 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 of not more than one year's base salary.</p> <p>Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Remuneration Committee, having regard to the terms of the service contract and the specific circumstances surrounding the termination, including whether the scenario aligns to an example under the approved leaver criteria, performance, service and health or other circumstances that may be relevant.</p> <p>Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal. If the employment is (a) terminated by the Company (other than for cause as defined in the contract) or (b) he resigned for a 'Good Reason' (as defined in his contract), he is entitled to a termination payment equal to (i) one year's base salary and (ii) a pro-rated bonus for the relevant financial year. He will also be entitled to a continuation of medical benefits for 18 months (or a cash payment in lieu).</p>
<b>Retirement benefits</b>	As governed by the rules of the relevant pension plan. No enhancement for leavers will be made.
<b>Annual Incentive Plan</b>	<p>The Remuneration Committee may exercise its discretion to make an annual incentive payment as part of the termination package.</p> <p>Where an executive director's employment is terminated after the end of a performance year but before the payment is made, the executive director will remain eligible for an annual incentive award for that performance year subject to an assessment based on performance achieved over the period. No award will be made in the event of gross misconduct.</p> <p>Where an executive director leaves by reason of death, ill-health, retirement, a transfer of business or redundancy, the Remuneration Committee may use its discretion to determine that an executive director is entitled to receive a bonus (subject to an assessment based on performance over the period and pro-rated for time) in respect of the financial year in which the individual ceased employment.</p> <p>If the Remuneration Committee regards it necessary to use their discretion, it must be shown how this is in the interests of the Company and its shareholders.</p> <p>The Committee's policy is not to award an annual incentive for any portion of the notice period not served.</p>
<b>Long-Term Incentive Plans</b>	<p>The treatment of outstanding share awards in the event that an executive director leaves is governed by the relevant share plan rules.</p> <p>Under the Long-Term Incentive Plans, awards and options generally vest and/or become exercisable where an executive director leaves by reason of ill-health, injury, disability, retirement with the agreement of the Company, redundancy or leaving in such circumstances as the Committee determines (each an 'approved leaver'). Awards and options generally continue and vest on the normal vesting date (or, in the case of Performance Shares, the first normal vesting date), unless the Committee determines that the awards should vest on cessation. Any performance conditions will be applied at the time of vesting.</p> <p>In the event of death, awards generally vest at the time of death subject to the satisfaction of any performance conditions at that time. Awards are then pro-rated as set out below.</p> <p>On the vesting and/or exercise of awards and/or options as set out above, the number of shares received will, unless the Committee decides otherwise, be reduced pro-rata to reflect the period in which the executive director was in employment as a proportion of the relevant vesting or performance period (as applicable).</p> <p>Where an executive director's employment is terminated for any other reason, his awards and options will lapse.</p> <p>If the Remuneration Committee regards it necessary to exercise its discretion as permissible under the share plan rules, then disclosure will include an explanation of how the application of discretion was in the best interests of the Company and its shareholders.</p> <p>Where an executive director's employment is terminated or an executive director is under notice of termination for any reason at the date of award of any Long-Term Incentive awards, no Long-Term Incentive awards will be made.</p>

**Consideration of employment conditions elsewhere in the Company**

The Remuneration Committee does not consult directly with employees as part of the process for reviewing executive pay. When considering salary increases for the executive directors, the Remuneration Committee considers the general level of salary increase across the Group and in the external market.

**Stakeholder considerations**

The Remuneration Committee conducts an annual programme of consultation with major shareholders in order to seek their input to the development of remuneration policy or plans.

# ANNUAL REMUNERATION REPORT

## Remuneration for the year ended 31 December 2013

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2013 and will, together with the annual statement of the Committee Chairman on pages 80 and 81, be proposed for an advisory vote by shareholders at the 2014 AGM. It has been prepared on the basis prescribed in The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

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### Single total figure of remuneration for the Chairman and non-executive directors

	Fees		Benefits		Other		Total	
	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000
<b>Chairman</b>								
Sir Richard Oliver <sup>1</sup>	725	725	15	20	n/a	n/a	740	745
<b>Non-executive directors</b>								
P M Anderson	95	95	–	–	23	23	118	118
Sir Roger Carr <sup>2</sup>	19	n/a	–	n/a	–	n/a	19	n/a
H Green	75	75	–	–	9	14	84	89
C M Grigg <sup>3</sup>	38	n/a	–	n/a	–	n/a	38	n/a
M J Hartnall <sup>4</sup>	n/a	25	n/a	–	n/a	–	n/a	25
Sir Peter Mason <sup>5</sup>	28	95	–	–	5	9	33	104
L A McIntire <sup>6</sup>	47	75	–	–	18	18	65	93
P Rosput Reynolds	75	75	–	–	23	23	98	98
N C Rose	119	100	–	–	14	14	133	114
C G Symon	95	95	–	–	23	23	118	118
I P Tyler <sup>7</sup>	49	n/a	–	n/a	5	n/a	54	n/a

<sup>1</sup> Retired from the Board on 1 February 2014.

<sup>2</sup> Appointed on 1 October 2013.

<sup>3</sup> Appointed on 1 July 2013.

<sup>4</sup> Retired in 2012.

<sup>5</sup> Retired on 8 May 2013.

<sup>6</sup> Resigned on 20 August 2013.

<sup>7</sup> Appointed on 8 May 2013.

The above table has been subject to audit.

The fee structure for 2013 for the non-executive directors on a per annum basis was as follows: (i) Chairman, Audit Committee: £100,000; (ii) Chairman, Corporate Responsibility Committee: £95,000; (iii) Chairman, Remuneration Committee: £95,000; (iv) Other non-executive directors: £75,000; and (v) Additional fee for Senior Independent Director: £20,000. These amounts are shown in the 'Fees' column above. A travel allowance of £4,500 per meeting is also paid on each occasion that a non-executive director's travel necessitates air travel of more than five hours (one way) to the meeting location, subject to a maximum of six travel allowances per year. These amounts are shown in the 'Other' column.

The benefits received by the Chairman, Sir Richard Oliver, include the private use of a chauffeur-driven car (2013 £14k; 2012 £20k) and spousal attendance at corporate events.

There were no payments made to former directors in the year under review.

**Single total figure of remuneration for the executive directors**

	Base salary <sup>1</sup>		Taxable benefits <sup>2</sup>		Bonus <sup>3</sup>		LTIP <sup>4</sup>		Pension <sup>5</sup>		Other <sup>6</sup>		Total	
	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000	2013 £'000	2012 £'000
I G King	963	963	41	34	1,156	1,205	–	–	338	371	1	1	2,499	2,574
P J Lynas	546	546	64	16	477	482	–	–	698	791	1	–	1,786	1,835
L P Hudson <sup>7</sup>	668	660	143	120	735	1,012	–	–	56	170	686	660	2,288	2,622

1 Linda Hudson's base salary throughout 2012 and 2013 was \$1,045,350 per annum and the variance in base salary relates to foreign exchange movement.

2 The benefits received by Ian King include the provision of a car allowance and the private use of a chauffeur-driven car (2013 £41k; 2012 £34k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2013 £17k; 2012 £16k). In addition, during 2013, he received a second residence allowance of £47k which, as reported in the prior year, is a more cost-effective option for the Company than requiring the relocation of his principal residence from outside London. This comprises a lump sum of £22,200, together with a monthly allowance totalling £33,300 in year one (commencing 1 April 2013), declining on a uniform basis to £6,660 in year five (such monthly allowances over the five-year period totalling £99,900), and zero thereafter. Clawback provisions operate during years one and two of this arrangement whereby he would be required to repay these monies on a pro-rata basis should he leave the Company in certain circumstances, e.g. resignation or termination. Linda Hudson's benefits include the provision of a cash allowance for a car and parking and the private use of a chauffeur-driven car (2013 £48k; 2012 £42k); medical and dental benefits (2013 £4k; 2012 £3k); and insured life and disability benefits (2013 £8k; 2012 £9k). In addition, her benefit figures also include £83k for the private use of a company aircraft (2012 £66k).

3 Further detail on bonus payments is provided on page 94.

4 This column relates to estimated or actual value of Long-Term Incentive Plans for which the performance period ended in the relevant financial year. The 2011 PSP<sup>EPS</sup> and the 2011 SMP awards (for which the performance periods ended on 31 December 2013) did not meet their performance conditions and lapsed (see page 95 for more detail). As reported in the prior year, the 2010 PSP and SMP awards (for which the performance periods ended on 31 December 2012) also lapsed.

5 The figures in this column have been calculated in line with the method set out in section 229 of the Finance Act 2004 using a capitalisation factor of 20 to assess the increase in the value of the pension promise over the year, net of inflation. Therefore, these figures are sensitive to salary increases and Consumer Prices Index (CPI) inflation as follows:

- Salary increase: As pensionable salary is averaged over three years, the figures for Peter Lynas still show the effect of the promotional increase following his appointment as Group Finance Director.
- CPI inflation: In a year with high CPI inflation, the increase in the value of the pension promise would be lower than in a year with lower CPI inflation.

Linda Hudson's 2013 pension figure is impacted by the change in accrual rate as detailed on page 97.

6 This column includes (i) for Ian King, the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) and Matching Shares under voluntary investment in the SIP; (ii) for Peter Lynas, Free Share awards under the SIP and tax-exempt health-screening; and (iii) for Linda Hudson, the value of the 2013 grant under the Restricted Share Plan (RSP) (and corresponding prior year figure). This award formed part of Linda Hudson's 2013 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached (see page 99 for calculation of the RSP figure).

7 Retired from the Board on 1 February 2014.

The above table has been subject to audit.



**Annual bonus**

Bonuses for the 2013 year are paid in March 2014. The breakdown of bonus measures, achievement and pay-out for each executive director is shown below. One-third of the bonus payment is subject to compulsory deferral into BAE Systems shares for a three-year period, for which there is no additional performance condition.

**Chief Executive**

Measures		Weight (as a percentage of target)	Actual performance against targets set				Target for 2013	Actual performance <sup>3</sup>	Percentage of maximum opportunity
			Below	Threshold	Target	Stretch			
Financial	Group EPS	40.0		<div><div></div></div>			44.1p	42.1p	38.4%
	Group cash	25.0		<div><div></div></div>			£(757)m	£(420)m	64.5%
	Group order intake	15.0		<div><div></div></div>			£19.0bn	£19.0bn	50.0%
Personal	Environment	2.5		<div><div></div></div>			See note 1 below		100.0%
	Safety	5.0		<div><div></div></div>				50.0%	
		Key strategic objectives	12.5		<div><div></div></div>			See note 2 below	
Total bonus (as a percentage of maximum)									53.4%

**Group Finance Director**

		Weight (as a percentage of target)	Actual performance against targets set				Target for 2013	Actual performance <sup>3</sup>	Percentage of maximum opportunity
Measures			Below	Threshold	Target	Stretch			
Financial	Group EPS	40.0	<div><div></div></div>				44.1p	42.1p	38.4%
	Group cash	25.0	<div><div></div></div>				£(757)m	£(420)m	64.5%
	Group order intake	15.0	<div><div></div></div>				£19.0bn	£19.0bn	50.0%
Personal	Environment	2.5	<div><div></div></div>				See note 1 below		100.0%
	Safety	5.0	<div><div></div></div>						50.0%
	Key strategic objectives		12.5	<div><div></div></div>				See note 2 below	
Total bonus (as a percentage of maximum)									54.6%

**President and Chief Executive Officer of BAE Systems, Inc.**

		Weight (as a percentage of target)	Actual performance against targets set				Target for 2013	Actual performance <sup>3</sup>	Percentage of maximum opportunity
Measures			Below	Threshold	Target	Stretch			
Financial	Group EPS	13.3		<div><div></div></div>			44.1p	42.1p	38.4%
	Group cash	8.3		<div><div></div></div>			£(757)m	£(420)m	64.5%
	Group order intake	5.0		<div><div></div></div>			£19.0bn	£19.0bn	50.0%
	BAE Systems, Inc. profit	26.7		<div><div></div></div>			\$1,726m	\$1,119m	20.5%
	BAE Systems, Inc. cash	16.7		<div><div></div></div>			\$(3,942)m	\$(3,547)m	100.0%
	BAE Systems, Inc. order intake	10.0	<div><div></div></div>				\$12.5bn	\$11.6bn	0.0%
	Personal	Environment	2.5		<div><div></div></div>			See note 1 below	
Safety		5.0		<div><div></div></div>			50.0%		
Key strategic objectives		12.5		<div><div></div></div>			See note 2 below		70.0%
Total bonus (as a percentage of maximum)									48.9%

1 The Group exceeded the 15% stretch target for reduction in Recordable Accident Rate (see page 28). However, the overall Group rating was reduced as a result of performance in the US business. All businesses demonstrated commitment to and met the stretch improvement targets set in respect of environmental performance.

2 Outcome determined by the Committee based on performance against a combination of base and premier objectives relating to delivery of the Group's strategic objectives and demonstration of leadership behaviours.

3 Adjusted to be on a like-for-like basis with the targets.

The above table has been subject to audit.

For bonus deferrals made in 2013 in respect of 2012 performance, the UK executive directors were granted a conditional award of matching shares against the gross value of the compulsory and voluntary element of annual incentive invested. Details of these awards are set out on page 99.

### Long-Term Incentive Plans (LTIPs)

Outcome of performance conditions ending on 31 December 2013	Target	Maximum	Actual	Percentage of target achieved
Annual average EPS growth (%)	46.6p	53.9p	41.8p	0%

The following awards had performance periods that ended on 31 December 2013:

#### 2011 Performance Share Plan (PSP)

- Performance conditions: half on relative TSR against comparator group, half on EPS growth of 5% to 11% per annum. As the EPS growth rate was not achieved, the related half of the award lapsed. The TSR performance condition ends on 31 March 2014 and has therefore not yet been tested. TSR performance to 31 December 2013 is shown in the chart below.

#### 2011 Share Matching Plan (SMP)

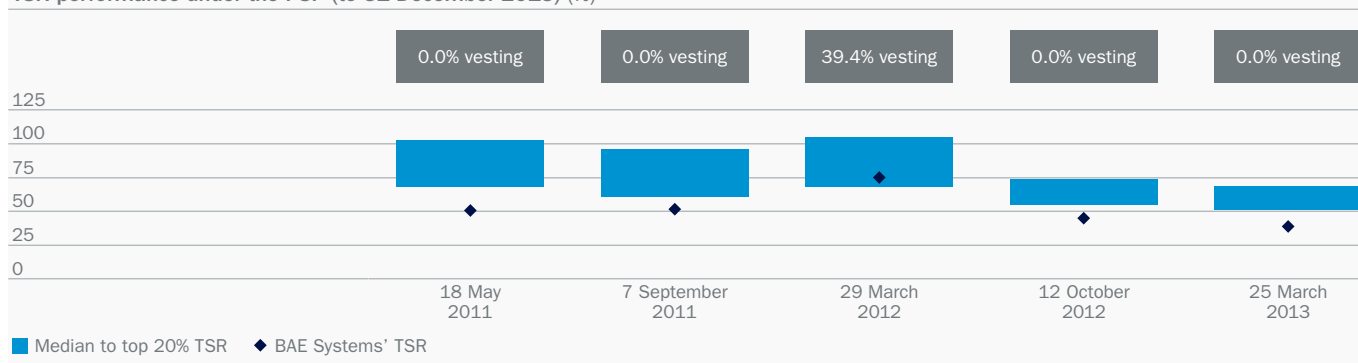
- 2:1 match on shares deferred from 2010 annual incentive based on a performance condition of EPS growth of 5% to 11% per annum. As this growth was not achieved, the 2011 SMP earned a nil match and the award will accordingly lapse.

#### Current position on outstanding LTIP awards

A summary of TSR performance to 31 December 2013 is illustrated in the chart below.

The coloured boxes show the range of TSR required for 25% vesting to full vesting and the diamonds show BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

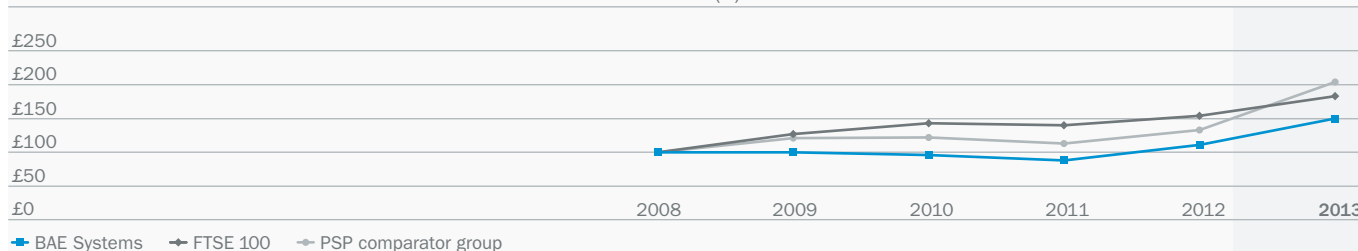
TSR performance under the PSP (to 31 December 2013) (%)



### Five-year TSR performance

The graph below shows the value by 31 December 2013, on a Total Shareholder Return basis, of £100 invested in BAE Systems on 31 December 2008 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 of which BAE Systems is a constituent member. The equivalent data is shown for the PSP comparator group.

Value at 31 December 2013 of £100 investment at 31 December 2008 (£)



### Change in Chief Executive's remuneration over five years

Chief Executive's single figure (£'000)	4,030	4,810	4,613	2,574	2,499
Bonus paid as a percentage of maximum	83.0%	71.0%	68.6%	55.6%	53.4%
LTI as a percentage of maximum vesting	65.5%	57.6%	44.3%	nil	nil

Note: Total remuneration includes the value of share plans vesting that were granted prior to appointment as Chief Executive.

## Percentage change from 2012 to 2013 in remuneration of director undertaking the role of Chief Executive

	Change in Chief Executive's remuneration %	Change in average UK employee <sup>1</sup> remuneration %
Salary	–	+2
Benefits <sup>2</sup>	+21	+2
Bonus	-4	+9

1 The UK population has been chosen as this employee comparator group reflects the local employment conditions of the Chief Executive for the purpose of this comparison.

2 The increase in Chief Executive benefits reported represents an increased usage of a chauffeur-driven car during 2013.

## Relative importance of spend on pay

The following charts set out underlying EBITA<sup>1</sup>, amounts paid in returns to shareholders, total employee costs and average headcount for the years ended 31 December 2012 and 2013.

Underlying EBITA <sup>1</sup> (£m)	Returns to shareholders (£m)	Total employee costs (£m)	Average headcount ('000)
<b>+3%</b>	<b>+37%</b>	<b>-5%</b>	<b>-5%</b>
2013 <b>1,925</b>	2013 <b>850<sup>2</sup></b>	2013 <b>5,054</b>	2013 <b>80</b>
2012 <b>1,862</b>	2012 <b>620</b>	2012 <b>5,300</b>	2012 <b>84</b>

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 33).

2 Includes £212m share buyback.

## Total pension entitlements

					Figures in the remuneration table on page 93		
Director	Age	Normal retirement date	Accrued benefit at 1 January 2013 <sup>1,2</sup> £ per annum	Accrued benefit at 31 December 2013 <sup>1,2</sup> £ per annum	Added pension value received in the year from defined benefit scheme <sup>2</sup> £	Added pension value received in the year from defined contribution scheme £	Total £
Ian King	57	01.05.18	722,675	759,728	338,335	–	338,335
Peter Lynas	55	01.04.20	333,662	378,285	697,601	–	697,601
Linda Hudson <sup>3</sup>	63	01.09.15	892,405	941,286	46,654	9,240	55,894

1 Accrued benefits are 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 The defined benefit figure includes both funded and unfunded arrangements for Ian King and Peter Lynas; and includes both Qualified and Non-Qualified plans for Linda Hudson.

3 Linda Hudson is a member of a US retirement plan which provides a cash sum at retirement equal to a percentage of career average pay. The accrued benefit shown above is a cash lump sum payable at normal retirement age. In addition, Linda Hudson participates in a Section 401(k) defined contribution arrangement set up for US employees in which the company will match employee contributions up to a limit. In 2013, the company paid contributions of £9,780 into this 401(k) arrangement.

The above table has been subject to audit.

Current UK executive directors are members of the BAE Systems Executive Pension Scheme (ExPS) and the BAE Systems 2000 Pension Plan (2000 Plan) which together provide a pension for executive directors payable at 62 of 1/30th of three-year final average salary for each year of service subject to the payment of members' contributions (currently 8%). Benefits paid prior to age 62 will be subject to actuarial reduction.

The ExPS tops up the underlying employee plan to provide a target benefit for executive directors payable from normal retirement age of 1/30th of Final Pensionable Pay (FPP) for each year of ExPS pensionable service (subject to a maximum of two-thirds of FPP). FPP is defined as annual base salary averaged over the last 12 months prior to leaving service in respect of service accrued to 5 April 2006 and 36 months prior to leaving in respect of service from 6 April 2006. The ExPS also provides a lump sum death-in-service benefit equal to four times base salary at date of death, and a spouse's death-in-service pension equal to two-thirds of the prospective pension at normal retirement age. Children's allowances are also payable, usually up to the age of 18. Spouses' pensions and children's allowances are also payable upon death in retirement and death after leaving the Company's employment with a deferred pension. Once in payment, pensions are increased annually by the rise in the Retail Prices 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.

The review of pension policies carried out in 2010 by the Committee concluded that the pension benefits should continue to be based on the Company's registered pension schemes and that, in appropriate circumstances, the Company will continue to have the option to offer an unfunded pension promise so as to mitigate the impact of further reductions to the Lifetime Allowance (introduced in 2006) and the impact of the reduced Annual Allowance. The current executive directors were given the choice to remain in the current arrangement and pay the increased tax or to take an unfunded promise: they both elected for the latter. The Committee has decided that in cases where the Company is to pay an unfunded promise, executives will be given the choice to commute some or all of the benefit for a taxable lump sum, or take it as pension. Where an unfunded pension is taken, ten years after retirement, the executive will be given a further opportunity to commute the residual value of the unfunded pension for a lump sum.

As stated above, Ian King and Peter Lynas already have an unfunded promise from the Company arising from the 2006 changes to the taxation of pension benefits, which has been extended to cover the reduced Annual Allowance at no additional cost to the Company.

Ian King and Peter Lynas are both members of the 2000 Plan, applicable to former employees of Marconi Electronic Systems (MES), and members of the ExPS with a normal retirement age of 62. The 2000 Plan provides a pension of 1/50th of Final Pensionable Earnings (FPE) for each year of pensionable service, payable from a normal retirement age of 65 and members pay contributions of 8% of Pensionable Earnings. FPE under the 2000 Plan is the best consecutive three-year average of base salary and bonus in the ten Plan Years prior to leaving, less an offset for State pensions. The Company decided in 2006 to limit pensionable bonuses in the 2000 Plan in the 2006/07 Plan Year to 20% of base salary and to 10% of base salary for the 2007/08 Plan Year and thereafter. However, there is a guarantee that the FPE figure for benefits in respect of service prior to 6 April 2007 will not be less than the FPE figure at 5 April 2007 to ensure that employees do not lose the benefit of contributions paid on past bonuses. Ian King and Peter Lynas joined the ExPS in 1999. Therefore, their individual total pensions are the sum of their 2000 Plan benefits plus the top up from the ExPS, most of which is provided through the unfunded promise referred to above.

Linda Hudson is a member of the 2006 Plan and a Non-Qualified Plan which provide a cash sum at retirement equal to a percentage of career average pay (salary plus bonus subject to a maximum bonus of 150% of salary). The cash accrual rate of the combined plans from 1 January 2010 was 14.1% of career average pay. From 1 January 2013, future accrual in the US pension arrangements changed for all employees and Linda Hudson will now receive a \$1,000 annual accrual from the 2006 Plan and, from the Non-Qualified Plan, a \$500 annual accrual plus 4.1% of salary plus bonus (subject to a maximum bonus of 150% of salary). For benefits commencing prior to age 65, the accrued benefit is reduced for interest only from age 65 to the benefit commencement date using the 30-Year Treasury Rate from the October prior to commencement. Linda Hudson also receives a company match on her contributions to her 401(k) plan up to a maximum contribution of 6% of salary, up to regulatory limits (for 2014 \$260,000). From 1 January 2013, the company match is 100%.

Jerry DeMuro is a member of the 2006 Plan and a Non-Qualified Plan which provide a cash sum at retirement equal to the sum of the annual accruals of \$1,000 from the 2006 Plan and a \$500 annual accrual from the Non-Qualified Plan. For benefits commencing prior to age 65, the accrued benefit is reduced for interest only from age 65 to the benefit commencement date using the 30-Year Treasury Rate from the October prior to commencement. Jerry DeMuro also receives a company match on his contributions to his 401(k) plan up to a maximum contribution of 6% of salary, up to regulatory limits (for 2014 \$260,000). From 1 January 2013, the company match is 100%. As at the date of this Annual Report, he has not made an election to contribute to the 401(k) plan and is therefore not eligible for any company match.



**Chairman and executive director changes**

With effect from 1 February 2014, Sir Roger Carr succeeded Sir Richard Olver as Chairman. To assist in completing handover activities and as agreed pursuant to the notice period under his letter of appointment, Sir Richard's services are being retained by the Company up to 16 May 2014. For these services, he will continue to be paid his current fee of £725,000 (pro-rata) and retain use of a chauffeur-driven car.

Sir Roger Carr was appointed to the Board as Chairman designate on 1 October 2013 at a fee of £75,000 per annum (pro-rata) until 1 February 2014 when he succeeded Sir Richard Olver as Chairman. His annual fee thereafter was £650,000 per annum (pro-rata). This fee will not be reviewed during his initial three-year term as Chairman.

Jerry DeMuro was appointed to succeed Linda Hudson as President and Chief Executive Officer of BAE Systems, Inc. on 1 February 2014 and joined the Board as an executive director on the same date. His salary on appointment was \$950,000, with a maximum bonus opportunity of 225% of salary, of which one-third will be deferred in shares for a period of three years. He will also receive LTIP awards at the levels contained within the executive directors' policy table. His pension arrangements are set out on page 97.

As previously announced, Linda Hudson retired as President and Chief Executive Officer of BAE Systems, Inc. and as an executive director of BAE Systems plc with effect from 1 February 2014. As a consequence, the following arrangements apply:

- For a period of 120 days from 1 February 2014, Linda Hudson shall be employed as Senior Vice President and Chief Executive Officer Emeritus for BAE Systems, Inc. on her existing terms performing transition activities to the new President and Chief Executive Officer of BAE Systems, Inc. and supporting handover with customers and external relationships. At the end of this 120-day period, 31 May 2014 (the 'Termination Date'), Linda Hudson shall retire from BAE Systems, Inc. and cease to be employed by BAE Systems, Inc.
- On ceasing to be employed by BAE Systems, Inc., in accordance with the terms of her employment agreement, Linda Hudson will be entitled to receive:
  - one year's base salary of \$1,045,350 to be paid six months after the Termination Date;
  - her bonus payment for the 2013 performance year of \$1,149,585, due in March 2014 as detailed on page 94. A bonus payment for 2014 of \$490,008 will be calculated on a pro-rata basis up to the Termination Date determined on an 'on-target' basis to be paid within 30 days of the Termination Date;
  - payment for all accrued but unused vacation as at the Termination Date; and
  - a lump sum payment equivalent to 18 months' medical premiums, including gross up, of \$17,741, to be paid six months after the Termination Date.
- Outstanding awards made under the Company's Long-Term Incentive Plans (as disclosed on page 102) will vest on the normal vesting dates subject to meeting the requirements of any applicable performance conditions. Awards shall be time pro-rated as specified in the relevant plan rules.

**External directorships**

Fees retained by executive directors in 2013 in respect of non-executive directorships were: Ian King £47,000 in respect of his non-executive directorship of Rotork p.l.c.; and Linda Hudson \$80,000 plus a \$160,000 stock award in respect of her non-executive directorship of Bank of America. These amounts are not included in the remuneration table on page 93.

## Scheme interests awarded during the financial year

Scheme	Type of interest	Date of grant	Number of shares	Basis of award	Face value of award <sup>1</sup> £	Exercise price £	Date to which performance is measured	Performance condition	Percentage of interests receivable if minimum performance achieved
<b>Ian King</b>									
PSP <sup>TSR</sup>	Performance Shares/nil cost option	25.03.13	154,771	62.5% of salary	601,904	nil	Three years to 31.12.15	TSR/secondary financial measure	25%
PSP <sup>EPS</sup>	Performance Shares/nil cost option	25.03.13	154,771	62.5% of salary	601,904	nil	Three years to 31.12.15	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	25.03.13	742,903	300% of salary	2,889,150	3.89	Three years to 31.12.15	TSR	25%
SMP <sup>3</sup>	Deferred bonus matching award	25.03.13	206,412	Compulsory $\frac{1}{3}$ of annual incentive	802,736	n/a	Three years to 31.12.15	EPS	0% <sup>2</sup>
<b>Peter Lynas</b>									
PSP <sup>TSR</sup>	Performance Shares/nil cost option	25.03.13	87,747	62.5% of salary	341,248	nil	Three years to 31.12.15	TSR/secondary financial measure	25%
PSP <sup>EPS</sup>	Performance Shares/nil cost option	25.03.13	87,747	62.5% of salary	341,248	nil	Three years to 31.12.15	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	25.03.13	421,187	300% of salary	1,637,996	3.89	Three years to 31.12.15	TSR	25%
SMP <sup>3</sup>	Deferred bonus matching award	25.03.13	82,468	Compulsory $\frac{1}{3}$ of annual incentive	320,718	n/a	Three years to 31.12.15	EPS	0% <sup>2</sup>
<b>Linda Hudson</b>									
PSP <sup>OCF</sup>	Performance Shares	25.03.13	127,907	72.5% of salary	497,430	n/a	Three years to 31.12.15	Long-term US operating cash	25%
PSP <sup>EPS</sup>	Performance Shares	25.03.13	127,908	72.5% of salary	497,434	n/a	Three years to 31.12.15	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	25.03.13	688,056	390% of salary	2,675,850	3.89	Three years to 31.12.15	TSR	25%
SMP <sup>3</sup>	Deferred bonus matching award	25.03.13	180,324	Compulsory $\frac{1}{3}$ of annual incentive	701,280	n/a	Three years to 31.12.15	EPS	0% <sup>2</sup>
RSP	Retention	25.03.13	176,424	100% of salary	686,113	n/a	n/a	n/a	n/a

The table above has been subject to audit.

1 The value of the award is calculated on the date of grant by reference to the middle market quotation at the close of the preceding day.

2 A sliding scale operates – further detail is provided in the summary of performance conditions overleaf.

3 Awards granted under the SMP in March 2013 relate to matching shares in respect of the bonus deferral for the year ended 31 March 2012. These awards were calculated on a 2:1 match on the gross value of one-third of the individual director's Annual Incentive for the 2012 financial year – further detail is provided in the summary of performance conditions overleaf. No further awards will be made under the SMP.

Note: PSP – Shares under award attract dividends prior to vesting. The nil cost options under the PSP are intended to be free share awards and are structured as an option to give the participant more flexibility as to the timing of the benefit. For the US executive director, grants under the PSP are classified as contingent awards (rather than share options) and are deliverable on the third, fourth and fifth anniversary of grant, subject to attainment of the performance condition.

**Description of share plans and summary of performance conditions****PSP**

Shares under award vest after satisfaction of the three-year performance condition. Shares under award attract dividends prior to vesting. Awards that vest are exercisable in three tranches between the third and seventh anniversary of vesting (being capable of exercise on a phased basis from the third, fourth and fifth anniversary of grant). For US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved.

Awards made to the UK executive directors since 2008 have been weighted 50% on the PSP<sup>EPS</sup> performance condition and 50% on the PSP<sup>TSR</sup> performance condition. Awards made to the US executive director were weighted in the same way until 2011. In 2012 and 2013, the weighting for the US executive director was 50% on the PSP<sup>EPS</sup> performance condition and 50% on the PSP<sup>OCF</sup> performance condition. The TSR comparator groups are shown below.

Plan	Performance condition
PSP <sup>EPS</sup>	Rate of average annual EPS growth over the three-year performance period, with nil vesting at 5% average growth per annum and 100% vesting at 11% average growth per annum, with vesting on a straight-line basis between these two parameters.
PSP <sup>TSR</sup>	The proportion of the award capable of exercise is determined by: <ol style="list-style-type: none"> <li>the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. No shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters; and</li> <li>whether there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA<sup>1</sup>; order book; turnover; risk; and underlying project performance.</li> </ol>
PSP <sup>OCF</sup>	Long-term operating cash performance at the level of the US businesses over a three-year performance period. The Committee is of the view that cash performance figures are commercially sensitive and that it would be detrimental to the interests of the Company to disclose them in advance.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

The TSR comparator group referred to above comprises:

Cobham	L-3 Communications	Raytheon
Finmeccanica	Lockheed Martin	SAIC
General Dynamics	Meggitt	Thales
ITT Exelis	Northrop Grumman	United Technologies

The comparator group for PSP<sup>TSR</sup> awards from 2008 to 2011 comprises:

Boeing	General Dynamics	Raytheon
Cobham	GKN	Rockwell Collins
Dassault Aviation	Goodrich <sup>1</sup>	Rolls-Royce
EADS	Honeywell International	Smiths Group
Embraer PN	Lockheed Martin	Thales
Finmeccanica	Northrop Grumman	United Technologies

1 Goodrich is now part of United Technologies.

**SMP**

The SMP was a standalone investment plan linked to the award under the Annual Incentive Plan. It operated for the final time in 2013 in relation to the annual incentive relating to 2012 performance. Executive directors were required to invest at least one-third (and maximum 50%) of their annual incentive into the SMP and were granted a conditional award of matching shares against the gross value of the annual incentive invested. The matching shares attract dividends during the three-year deferral period, released on vesting of any matching shares.

Plan	Performance condition
SMP	In respect of a three-year performance period, nil match for average EPS growth of 5% per annum increasing uniformly to a maximum 2:1 match at 11% growth per annum.

**ExSOP<sup>2012</sup>**

Options granted are normally exercisable between the third and tenth anniversary of their grant, subject to the performance condition being achieved.

Plan	Performance condition
ExSOP <sup>2012</sup>	The proportion of the award capable of exercise is determined by the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. No shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters.

**RSP**

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US. The shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date).

## Statement of directors' shareholdings and share interests

### Minimum Shareholding Requirement (MSR)

Executive directors are compulsorily required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and Long-Term Incentive schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

The following table sets out MSR Initial Value and Subsequent Value:

Director	Initial Value	Subsequent Value
Ian King	150%	300%
Peter Lynas	100%	200%
Linda Hudson	175%	350%

Ian King and Peter Lynas were both in excess of their 'Subsequent Value' MSR at 31 December 2013. Following the announcement in 2013 of Linda Hudson's forthcoming retirement, the Committee agreed to reduce her MSR to 175% and she subsequently retained a holding to that level.

There are no shareholding requirements for the Chairman or the non-executive directors.

### Share interests as at 31 December 2013 (or on ceasing to be a director of the Company)

The interests of the directors who served during the year ended 31 December 2013 (or earlier date of cessation as a director) in the shares of BAE Systems plc, or scheme interests in relation to those shares, were as follows:

	Shares	Scheme interests: Options and awards over shares				Total scheme interests
		Share awards with performance	Share awards without performance	Share options with performance	Share options with performance: Vested but unexercised	
P M Anderson	60,000	–	–	–	–	–
Sir Roger Carr	–	–	–	–	–	–
H Green	–	–	–	–	–	–
C M Grigg	–	–	–	–	–	–
L P Hudson <sup>1</sup>	264,846	1,490,991	515,227	1,542,390	133,740	3,682,348
I G King	1,600,741	1,111,337	–	3,152,058	573,916	4,837,311
P J Lynas	311,400	217,176	–	1,649,336	162,795	2,029,307
Sir Peter Mason <sup>2</sup>	5,283	–	–	–	–	–
L A McIntire <sup>3</sup>	–	–	–	–	–	–
Sir Richard Olver <sup>1</sup>	53,343	–	–	–	–	–
P Rosput Reynolds	21,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
C G Symon	20,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–

1 Retired from the Board on 1 February 2014. 2 Retired from the Board on 8 May 2013. 3 Resigned from the Board on 20 August 2013.

The above table has been subject to audit.

The interests of directors include those of their connected persons. The shares held by Paula Rosput Reynolds are represented by 300 American Depositary Shares. Details of the share interests in options and awards held by the executive directors as at 31 December 2013 are given on page 102, together with details of share options exercised in 2013.

Awards under the PSP are classified as share awards with performance for the US executive director and as share options with performance for the UK executive directors.

Changes to the interests of the current directors listed in the table above since 31 December 2013 comprise: (i) Ian King who has acquired an additional 86 shares under the partnership and matching shares elements of the Share Incentive Plan so that his beneficial shareholding at the date of this report stood at 1,600,827; (ii) Sir Roger Carr who has acquired 50,246 shares; and Chris Grigg who has acquired 24,555 shares. Jerry DeMuro, who was appointed to the Board on 1 February 2014, did not have an interest in the Company's shares at the date of this report.



**Breakdown of scheme interests: Options and awards held as at 31 December 2013**

<b>Ian King</b>	31 December 2013	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>EPS</sup>	32,610 <sup>1</sup>	08.09.08	nil	08.09.13
PSP <sup>EPS</sup>	46,412 <sup>2</sup>	24.03.09	nil	24.03.14
PSP <sup>TSR</sup>	346,707 <sup>3</sup>	18.05.11	nil	18.05.14
PSP <sup>EPS</sup>	346,707 <sup>4</sup>	18.05.11	nil	18.05.14
PSP <sup>TSR</sup>	199,968 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>EPS</sup>	199,969 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>TSR</sup>	154,771 <sup>3</sup>	25.03.13	nil	25.03.16
PSP <sup>EPS</sup>	154,771 <sup>3</sup>	25.03.13	nil	25.03.16
	<b>1,481,915</b>			
ExSOP	221,903 <sup>1</sup>	24.03.05	2.64	24.03.08
ExSOP	145,443 <sup>1</sup>	12.04.06	4.28	12.04.09
ExSOP	173,960 <sup>1</sup>	30.03.07	4.57	30.03.10
ExSOP <sup>2012</sup>	959,850 <sup>3</sup>	29.03.12	3.01	29.03.15
ExSOP <sup>2012</sup>	742,903 <sup>3</sup>	25.03.13	3.89	25.03.16
	<b>2,244,059</b>			
SMP	425,877 <sup>4</sup>	18.05.11	n/a	18.05.14
SMP	479,048 <sup>3</sup>	29.03.12	n/a	29.03.15
SMP	206,412 <sup>3</sup>	25.03.13	n/a	25.03.16
	<b>1,111,337</b>			

<b>Linda Hudson</b>	31 December 2013	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>EPS</sup>	14,821 <sup>2</sup>	24.03.09	nil	24.03.14
PSP <sup>TSR</sup>	147,376 <sup>3</sup>	18.05.11	nil	18.05.14
PSP <sup>EPS</sup>	147,376 <sup>4</sup>	18.05.11	nil	18.05.14
PSP <sup>OCF</sup>	158,818 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>EPS</sup>	158,819 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>OCF</sup>	127,907 <sup>3</sup>	25.03.13	nil	25.03.16
PSP <sup>EPS</sup>	127,908 <sup>3</sup>	25.03.13	nil	25.03.16
	<b>883,025</b>			
ExSOP	133,740 <sup>1</sup>	30.03.07	4.57	30.03.10
ExSOP <sup>2012</sup>	854,334 <sup>3</sup>	29.03.12	3.01	29.03.15
ExSOP <sup>2012</sup>	688,056 <sup>3</sup>	25.03.13	3.89	25.03.16
	<b>1,676,130</b>			
SMP	219,610 <sup>4</sup>	18.05.11	n/a	18.05.14
SMP	208,032 <sup>3</sup>	29.03.12	n/a	29.03.15
SMP	180,324 <sup>3</sup>	25.03.13	n/a	25.03.16
	<b>607,966</b>			
RSP	119,743	18.05.11	n/a	18.05.14
RSP	219,060	29.03.12	n/a	29.03.15
RSP	176,424	25.03.13	n/a	25.03.16
	<b>515,227</b>			

1 Share options vested but unexercised.

2 Exercisable on the fifth anniversary of grant.

3 Performance condition yet to be tested.

4 The outstanding award will lapse after the end of the financial year having not met the performance condition.

<b>Peter Lynas</b>	31 December 2013	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>EPS</sup>	9,025 <sup>2</sup>	24.03.09	nil	24.03.14
PSP <sup>TSR</sup>	136,350 <sup>3</sup>	18.05.11	nil	18.05.14
PSP <sup>EPS</sup>	136,350 <sup>4</sup>	18.05.11	nil	18.05.14
PSP <sup>TSR</sup>	113,372 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>EPS</sup>	113,372 <sup>3</sup>	29.03.12	nil	29.03.15
PSP <sup>TSR</sup>	87,747 <sup>3</sup>	25.03.13	nil	25.03.16
PSP <sup>EPS</sup>	87,747 <sup>3</sup>	25.03.13	nil	25.03.16
	<b>683,963</b>			
ExSOP	13,386 <sup>1</sup>	22.12.05	3.56	22.12.08
ExSOP	75,887 <sup>1</sup>	12.04.06	4.28	12.04.09
ExSOP	73,522 <sup>1</sup>	30.03.07	4.57	30.03.10
ExSOP <sup>2012</sup>	544,186 <sup>3</sup>	29.03.12	3.01	29.03.15
ExSOP <sup>2012</sup>	421,187 <sup>3</sup>	25.03.13	3.89	25.03.16
	<b>1,128,168</b>			
SMP	33,552 <sup>4</sup>	18.05.11	n/a	18.05.14
SMP	101,156 <sup>3</sup>	29.03.12	n/a	29.03.15
SMP	82,468 <sup>3</sup>	25.03.13	n/a	25.03.16
	<b>217,176</b>			

**Options exercised during 2013**

<b>Ian King</b>	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP <sup>EPS</sup>	38,463	nil	07.05.08	10.04.13	3.93
PSP <sup>EPS</sup>	32,609	nil	08.09.08	10.04.13	3.93
PSP <sup>EPS</sup>	46,411	nil	24.03.09	10.04.13	3.93
ExSOP	318,314	1.72	30.09.03	05.03.13	3.64
ExSOP	272,388	2.01	30.03.04	01.08.13	4.51

The three PSP options exercised by Ian King attracted reinvested dividends which equated to an additional 15,274 shares.

<b>Peter Lynas</b>	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP <sup>EPS</sup>	12,660	nil	26.03.08	08.04.13	3.88
PSP <sup>EPS</sup>	9,024	nil	24.03.09	08.04.13	3.88

The two PSP options exercised by Peter Lynas attracted reinvested dividends which equated to an additional 3,056 shares.

The tables on this page have been subject to audit.

**Performance conditions**

Performance conditions for the PSP, ExSOP<sup>2012</sup> and SMP are detailed on page 100. The ExSOP (Executive Share Option Plan) was established in 2001 and its ten-year life expired in 2011. Options granted under this plan are usually exercisable between the third and tenth anniversary of grant. The existing options granted between 2005 and 2007 have met their performance condition (EPS growth of 5% or more per annum over the three-year performance period).

**Statement of voting**

Shareholder voting on the resolution to approve the Remuneration report put to the 2013 AGM was as follows:

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,205,236,703	92.33	183,202,336	7.67	2,388,439,039	56,898,372

**Remuneration Committee details**

The Committee members comprise Carl Symon (Chairman), Chris Grigg and Nick Rose. Chris Grigg joined the Committee on 1 July 2013 and Lee McIntire served on the Committee until he stepped down from the Board on 20 August 2013. Advisers to the Remuneration Committee are shown below.

Adviser	Services provided	Appointment	Governance	Fees
Kepler Associates	Advises Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	Kepler engage directly with the members of the Committee.  Kepler do not undertake any other work for the Company.  Kepler are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£24,675  Fee basis: Hourly
Linklaters	Legal services, principally the drafting of share plan rules in accordance with the policy determined by the Committee.	By the Company with the approval of the Committee.	Only provide legal drafting and review services, do not advise the Committee.  The Committee is aware that Linklaters are one of a number of legal firms that provide legal advice and services to the Company on a range of matters.  Linklaters are regulated by the Law Society.	£14,438 (in respect of services provided to the Committee)  Fee basis: Hourly
PricewaterhouseCoopers	Information on market trends and the competitive positioning of packages.	By the Company at the request of the Committee.	The Committee is aware that PricewaterhouseCoopers provide a variety of other services to the Company, including tax and accounting.  The nature of the advice provided to the Committee is limited to market comparator information and does not include advice on the design of remuneration policy.  PricewaterhouseCoopers are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£66,300 (in respect of services provided to the Committee)  Fee basis: Hourly
Hewitt New Bridge Street	Advice on the TSR outcomes as required for assessing the performance condition under the Performance Share Plan.	By the Company.	The Committee is aware that Hewitt New Bridge Street provide a variety of other HR-related services to the Company.  The nature of the advice provided to the Committee is limited to factual information concerning the performance of the Company's shares.  Hewitt New Bridge Street are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£12,250 (in respect of services provided to the Committee)  Fee basis: Fixed fee

During the year, the Committee received material assistance and advice on remuneration policy from the Group HR Director, Lynn Minella, and the Human Resources Director, Reward, Paul Farley. Sir Richard Oliver, in his capacity as Chairman, and Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

The non-executive directors' fees are set by the Non-Executive Directors' Fees Committee which, during 2013, comprised Sir Richard Olver, Philip Bramwell, Linda Hudson and Ian King; from 1 February 2014, this committee comprises Sir Roger Carr, Philip Bramwell, Jerry DeMuro and Ian King.

**Directors' remuneration in the year ending 31 December 2014**

As stated in the Committee Chairman's letter on page 81, for the purposes of the Companies Act 2006, the Policy will take legal effect on 1 January 2015. We intend in practice to operate the Directors' remuneration policy from the 2014 AGM. As detailed in the Committee Chairman's statement on page 81, the salaries of the Chief Executive and Group Finance Director remain unchanged in 2014, and the remuneration package for the newly appointed President and Chief Executive Officer of BAE Systems, Inc. is set out on page 98. The performance measures and weightings for 2014 for the Annual Incentive and Long-Term Incentives are set out in the Directors' remuneration policy on pages 83 to 85. The Committee is of the view that bonus targets for the Annual Incentive are commercially sensitive and that it would be detrimental to the Company to disclose them before the start of the financial year. The targets will be disclosed retrospectively after the end of the relevant financial year.

# DIRECTORS' REPORT

## WHAT YOU WILL FIND IN THIS SECTION

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### **106** PRINCIPAL RISKS

Details of the Group's principal risks, including a description of how those risks are being mitigated.

### **112** SUSTAINABILITY

Further information on how the Group ensures that it has the processes to support the long-term sustainability of the Group.

### **120** OTHER STATUTORY AND REGULATORY INFORMATION

Other information required to be disclosed in the Annual Report, including the responsibility statements of the directors in respect of the report.



# PRINCIPAL RISKS

The Group's principal risks are identified below, together with a description of how the Group mitigates those risks.

## Defence spending

HIGH IMPACT

MEDIUM IMPACT

The Group is dependent on defence spending.

### Description

The Group's core businesses are primarily defence-related, selling products and services directly and indirectly, mainly to the US, UK, Saudi Arabian and other national governments. Defence spending depends on a complex mix of political considerations, budgetary constraints, and the ability of the armed forces to meet specific threats and perform certain missions, and, as such, may be subject to significant fluctuations from year to year. With constraints on government expenditure in a number of the Group's markets and countries in the Eurozone area experiencing serious financial difficulties, affordability continues to be a key focus for customers.

### Impact

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

### Mitigation

The Group's business is geographically spread across UK, US and international markets and its products are marketed across a range of defence markets. The Group has a highly sustainable services business, which is an area for growth as customers' operations and maintenance budgets come under pressure. The Group continues to use realistic assumptions to underpin its financial and operational planning.

Efforts to reduce the US government's budget deficit are expected to continue to impact government spend. A bipartisan budget proposal was approved in December 2013 that mitigates the full impact of the Sequester for 2014 and 2015. The Group expects lower defence spending than previously programmed, but the cuts are not expected to be as significant or indiscriminate as they would have been under Sequestration.

Notwithstanding the continued pressure on many areas of government spend in the UK, the outlook for the Group's UK defence business remains stable.

In Saudi Arabia, regional tensions continue to dictate that defence remains a high priority.

➔ For more information on the Group's multiple markets see page 14

## Government customers

HIGH IMPACT

MEDIUM IMPACT

The Group's largest customers are governments.

### Description

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

As a result of these audits and reviews, costs and prices under these contracts may be subject to adjustment.

### Impact

The termination of one or more of the contracts for the Group's programmes by governments, the failure of the relevant agencies to obtain expected funding appropriations for the Group's programmes, or a deterioration in the Group's relationship with any of its key government customers and corresponding reduction in contract awards, could have a material adverse effect on the Group's future results and financial condition.

### Mitigation

The Group regularly reviews performance in its markets and the Executive Committee continues to work closely with the government customers in these markets to ensure the Group's strategy is aligned with theirs.

In the event of a customer termination for convenience, the Group would typically be paid for work done and commitments made at the time of termination. Having sovereign governments as major customers offers the benefits of dealing with mature procurement organisations with which the Group can have long-standing business relationships, and well-established and understood terms of trade.

➔ For more information on the Group's strategy see page 7

## Global market

HIGH IMPACT

MEDIUM IMPACT

The Group operates 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: political changes could lead to changes in the business environment in which the Group operates; economic downturns, political instability and civil disturbances could disrupt the Group's business activities; 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; and burdensome taxes or tariffs could be introduced.

### Impact

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

### Mitigation

The Group has a balanced portfolio of businesses across its markets.

➞ For more information on the Group's multiple markets see page 14

## Contract award timing

HIGH IMPACT

MEDIUM IMPACT

The Group is dependent on the timing of award of defence contracts.

### Description

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

### Impact

Amounts receivable under the Group's defence contracts can be substantial and, therefore, the timing of awards, or failure to receive anticipated awards, could materially affect the Group's profits and cash flows 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.

➞ For more information on the Group's major programmes see page 37

## Large contracts

HIGH IMPACT

MEDIUM IMPACT

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

### Description

A significant proportion of the Group's revenue comes from a small number of large contracts. Each of these contracts, which are primarily in the Platforms & Services (UK) and Platforms & Services (International) reporting segments, is typically worth or potentially worth over £1bn.

### Impact

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

### Mitigation

To mitigate risk on UK Ministry of Defence contracts, development programmes are normally contracted with appropriate levels of risk being initially held by the customer. Subsequent production programmes are priced when a platform's development has reached sufficient maturity. A variety of contract structures are used to mitigate risk on production programmes, such as incentive arrangements, whereby the customer and contractor share cost savings and overruns against target prices.

The Group has a well-balanced spread of programmes and significant order backlog, which provides long-term visibility. The Board regularly reviews the Group's performance on these large contracts and the Executive Committee continues to work closely with the relevant customers to ensure the Group's strategy is aligned with theirs.

➞ For more information on the Group's order backlog by major programme and reporting segment see page 37

## Fixed-price contracts

HIGH IMPACT

MEDIUM IMPACT

The Group has fixed-price contracts.

### Description

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

### Impact

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

### Mitigation

The Group has reduced its exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. To manage

contract-related risks and uncertainties, contracts are managed under the Group's mandated Lifecycle Management (LCM) process at the operational level.

Robust bid preparation and approvals processes are well established throughout the Group, with decisions required to be taken at the appropriate level in line with clear delegations of authority. The consistent application of metrics is used to support the review of individual contract performance.

➔ For more information on LCM which mandates project management processes see page 69

## Component availability, subcontractor performance and key suppliers

HIGH IMPACT

MEDIUM IMPACT

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 compliance with applicable terms and conditions.

### Impact

Some of the Group's suppliers or subcontractors may be impacted by the economic environment and constraints on available financing, which could impair their ability to meet their obligations

to the Group. In 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 it may utilise. In some instances, the Group is dependent on one or a limited number of suppliers. If any of these suppliers or subcontractors fails to meet the Group's needs, the Group may not, in the short term, have readily available alternatives, thereby impacting its ability to complete its customer obligations satisfactorily and in a timely manner,

which could have a negative impact on the Group's future results and financial condition.

### Mitigation

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

➔ For more information on suppliers see page 118

## Laws and regulations

HIGH IMPACT

MEDIUM IMPACT

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

### Description

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

### Impact

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

### Mitigation

During the year, the Group has continued to add resources dedicated to legal and regulatory compliance in order to enhance further 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 and training processes.

A uniform global policy and process for the appointment of advisers engaged in business development is in effect.

Pursuant to its commitments concerning ongoing regulatory compliance made in the course of the 2011 settlement with the US Department of State, the Group appointed a Special Compliance Official in 2011 for a period of not less than three years to monitor the Group's compliance with its commitments under that settlement and its compliance obligations going forward.

➔ For more information on the Group's approach to business conduct see page 112

## Competition

HIGH IMPACT

MEDIUM IMPACT

The Group's business is subject to significant competition.

### Description

The Group's businesses are subject to competition from national and multi-national firms with substantial resources and capital, and many contracts are obtained through a competitive bidding process, including contracts where the Group is the current incumbent.

The Group's ability to compete for contracts depends in particular on: the strength of its intellectual property rights and technical know-how; the effectiveness and innovation of its research and development programmes; its ability to offer better programme performance than its competitors at a lower cost to its customers; and the readiness of its facilities, equipment and personnel to undertake the programmes for which it competes.

In some instances, governments direct to a single supplier all work for a particular programme, commonly known as sole-source programmes. 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 and security-related products and services can, in certain countries, be awarded on the basis of home country preference.

### Impact

The Group's business and future results may be adversely impacted if it is unable to compete adequately in the markets in which it operates.

### Mitigation

The Group's global, multi-market presence, balanced portfolio of businesses, leading capabilities and performance continue to address this risk. In particular, the Group invests in research and development, continues to reduce its cost base and improve efficiencies, and has the mandated Lifecycle Management process that promotes the application of best practice programme execution.

➔ For more information on the Group's multiple markets see page 14

## Pension funding

HIGH IMPACT

MEDIUM IMPACT

The Group has an aggregate funding deficit in its defined benefit pension schemes.

### Description

The Group operates certain defined benefit and defined benefit/defined contribution hybrid pension schemes. At present, in aggregate, there is an actuarial deficit between the value of the projected liabilities of these schemes and the assets they hold.

### Impact

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

### Mitigation

Following triennial funding valuations of the Group's two largest UK pension schemes in 2011, revised deficit recovery plans were agreed in 2012. 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 appropriate. The results of these reviews are discussed with the Board and appropriate action taken.

In future, the growth of the defined benefit liabilities is expected to be curtailed as follows:

- With effect from April 2012, new employees in the UK are offered defined contribution pension benefits rather than the previous defined benefit/defined contribution hybrid pension benefits;
- With effect from January 2013, all employees in the US are offered membership of a defined contribution scheme (401(k)) and no longer accrue salary-related benefits in defined benefit schemes;
- In February 2013, with the agreement of the Company, the trustees of the BAE Systems 2000 Pension Plan entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. In December 2013, similar arrangements were entered into, with Legal & General, by the trustees of the Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme, covering £0.9bn and £0.8bn of pension scheme liabilities, respectively. These arrangements will reduce the funding volatility relating to increasing life expectancy; and
- In August 2013, with the support of the trustees of the BAE Systems Pension Scheme, the Group launched a pension increase exchange, offering pensioners the option to exchange increases on part of their pensions for higher immediate non-increasing pensions. For those who take up the offer, all future inflation risk to the Group is removed in respect of part of their pensions. Exchangeable pension forms approximately 50% of the scheme's pensions in payment and the option was given to approximately 18,000 pensioners in 2013. It is expected that, once the exercise concludes, the take-up rate amongst this group will be approximately one-third.

➔ For more information on the Group's pension accounting and funding valuations, and deficit recovery plans see page 162



## Export controls and other restrictions

HIGH IMPACT

MEDIUM IMPACT

The Group is subject to export controls and other restrictions.

### Description

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

### Impact

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

### Mitigation

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

➔ For more information on exports see page 14

## Acquisitions

HIGH IMPACT

MEDIUM IMPACT

The anticipated benefits of acquisitions may not be achieved.

### Description

The Group considers investment in value-enhancing acquisitions where market conditions are right and where they deliver on its strategy. Whether the Group realises the anticipated benefits from these transactions depends upon the successful integration of the acquired businesses, as well as their post-acquisition performance in the markets in which they operate.

### Impact

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

### Mitigation

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

➔ For more information on the Group's recent M&A activity see page 173

## Consortia and joint ventures

HIGH IMPACT

MEDIUM IMPACT

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 degrees of control. The risk of failure or the risk of disagreement, particularly in those that require the unanimous consent of all members with regard to major decisions, is inherent in any jointly controlled entity.

### Impact

In the event of failure or 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 future results may be adversely affected.

### Mitigation

The Group seeks to participate only in ventures in which its interests are complementary to those of its partners, and has formal systems and procedures in place to monitor the performance of such business arrangements.

➔ For more information on the Group's principal joint ventures see page 153

Exchange rates

HIGH IMPACT  
MEDIUM IMPACT

The Group is exposed to volatility in currency exchange rates.

<b>Description</b> 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, Euro and Saudi Riyal.	<b>Impact</b> Significant fluctuations in exchange rates to which the Group is exposed could have a material adverse effect on the Group's future results and financial condition.	<b>Mitigation</b> In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved as exceptions by the Treasury Review Management Committee. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of foreign subsidiaries and equity accounted investments it regards as long-term investments.
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For more information on financial risk management see page 176

Cyber security

HIGH IMPACT  
MEDIUM IMPACT

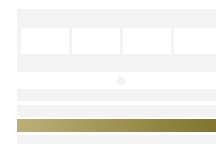
The Group could be negatively impacted by information technology security threats.

<b>Description</b> As a defence, aerospace and security company, the security threats faced by the Group include threats to its information technology infrastructure, unlawful attempts to gain access to its proprietary or classified information and the potential for business disruptions associated with information technology failures.	<b>Impact</b> Failure to combat these risks effectively could negatively impact the Group's reputation among its customers and the public, cause disruption to its business operations, and could result in a negative impact on the Group's future results and financial condition.	<b>Mitigation</b> The Group has a broad range of measures in place, including appropriate tools and techniques, to monitor and mitigate this risk.
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For more information on the Group's Cyber & Intelligence reporting segment see page 43

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

# SUSTAINABILITY



BAE Systems manages the current impacts of its operations and products, and anticipates the future global business environment to ensure that it has processes in place to support the long-term sustainability of the Group.

During 2013, the Group focused on four priorities:

- **Ethics and governance** – continue to improve and evolve the Group's business conduct programme.
- **Employee safety and wellbeing** – continue to improve safety standards across all our operations and demonstrate improvements against key safety indicators, including a 10% improvement in the Recordable Accident Rate.
- **Diversity and inclusion** – increase diversity and inclusion within the organisation in accordance with business goals.
- **Operational environmental impacts** – set environmental improvement targets to include energy, water and waste.

Objectives for safety and environment were annual incentive-related for senior executives, with 5% of total remuneration linked to employee safety and 2.5% to progress against environmental targets (see page 94 of the Annual remuneration report).

Objectives for diversity and inclusion were set within each executive's personal development plan to drive alignment of activity with functional and business issues. An assessment of progress against these objectives is determined by the Chief Executive as part of the overall performance review.

An overview of progress against 2013 priorities is discussed on the following pages and within the reporting segment reviews (see pages 38 to 61).

MEMBER OF

**Dow Jones Sustainability Indices**

In Collaboration with RobecoSAM

*In September 2013, BAE Systems was confirmed as a member of the Dow Jones Sustainability World and European Indices. This reflected improvements in external reporting and engagement on sustainability issues.*

## A culture of integrity

### Responsible business conduct

BAE Systems continues to embed its ethics programme globally, driving the right behaviours by supporting employees in making ethical decisions and embedding responsible business practices.

In 2013, Lord Gold, the monitor appointed by the US Department of Justice, concluded his three-year term. His final report confirmed the progress made and the robustness of the processes in place to ensure high standards of ethical business conduct are maintained.

The Group's Code of Conduct sets out the principles and standards of business conduct expected of all employees. It provides them with practical guidance on how to deal with situations that may arise in their day-to-day activities. Guidance is also included on where employees can seek further advice.

If employees (or third parties) need help or guidance in addition to that provided by the Code of Conduct, or want to report a concern, they can call the Ethics Helpline, which is managed by a third party and is available 24 hours of every day using a freephone number from most countries. The caller has the option to speak to someone in their own language. Employees can also get independent advice and support, or report concerns via Ethics Officers, now in place across the businesses, or via the Ethics Helpline e-mail address, which is also made available to third parties via the Group's website.

The Code of Conduct and related policies are supported by regular mandatory training for all employees. During 2013, the Group provided export control training for all senior employees, which explained the standards required on export control and International Traffic in Arms Regulations. Senior executives and business leaders completed further training on the Advisers, Gifts and Hospitality, Facilitation Payments, Community Investment and Conflicts of Interest mandated policies in the Operational Framework.

Recognising the increasing use and importance of IT and social media, all employees using the Group's IT system completed a number of training modules on IT security. BAE Systems operates in a heavily regulated and secure sector, and it must ensure that employees are mindful of the risks that are faced both by the organisation and as individuals with access to highly confidential and sensitive material. The Group's social media guidelines have been developed to help employees and contractors understand how to minimise those risks and use digital and social media responsibly.

All employees will participate in Code of Conduct refresher training in 2014. This will be developed to address current key issues, such as the use of social media and security of information.

During 2013, 1,043 enquiries were reported to Ethics Officers and through the Ethics Helpline. The Group has seen a steady increase in reports and requests for guidance to Ethics Officers as they become more established within their businesses.

If employees are found to be in breach of the Group's Code of Conduct or related policies, they will potentially be subject to disciplinary action. In 2013, 265 employees were dismissed for reasons relating to breaches of the Group's standards and policies, primarily for personnel and workplace issues.

### Governance

Clear governance structures and visible leadership play a vital role in embedding corporate responsibility.

The Chief Executive has overall responsibility for the Group's ongoing commitment to corporate responsibility. He is supported by the Board and Corporate Responsibility Committee in ensuring that appropriate policies, systems, reporting structures and metrics are in place to achieve the Group's ethical, social and environmental performance objectives.

### Enquiries to Ethics Helpline^

2013	1,043
2012	1,024
2011	1,011
2010	734
2009	870

All enquiries reported to Ethics Officers and via the Ethics Helpline were reviewed and reported either to the Ethics Review Committee or, in BAE Systems, Inc., to the Ethics Review Oversight Committee.

### 2013 enquiries to Ethics Helpline^

1	383
2	194
3	189
4	89
5	59
6	129

- 1 Guidance and advice
- 2 Employee relations and conduct
- 3 Management practices
- 4 Accounting charges practices
- 5 Open enquiries\*\*
- 6 Other

\*\* US category only

### Dismissals for reasons relating to unethical behaviour\*

2013	265
2012	292
2011	298
2010	355
2009	485

If an employee is found to be in breach of the Group's Code of Conduct or any other relevant policies, appropriate disciplinary action, which may include dismissal, is taken.

The Group's Corporate Responsibility team reports directly to the Chief Executive, and supports the Executive Committee in embedding and driving processes and performance. Performance is measured and risk monitored throughout the year via the Group's six-monthly Operational Assurance Statement (see page 69) and Quarterly Business Review (see page 69) processes.

The Group's Internal Audit team also assesses the effectiveness of policies and processes relating to key areas of ethical and reputational risk.

The Managing Director, Corporate Responsibility is a direct report to the Chief Executive and supports the Group's Corporate Responsibility Committee.

The Group's governance framework, as described in the Operational Framework, covers the products we make and export. The Group's Responsible Trading Principles, Product Trading Policy and Pursuit of Export Opportunities Policy help employees make informed decisions about the business opportunities the Group pursues and to address any responsible trading risks, including risks associated with the product and its intended end use, the country of origin and delivery, and the customer.

#### Improving industry standards

The Group continues to support the improvement of ethical standards across the defence industry.

During 2013, the Group participated in the International Forum on Business Ethical Conduct (IFBEC) for the Aerospace and Defence Industry, both as Chair and as Task Force members. IFBEC is committed to promoting high ethical standards through the adoption of Global Principles of Business Ethics for the Aerospace and Defence Industry (<http://ifbec.info/>).

BAE Systems regularly engages with other companies to understand progress and the latest status of thinking on ethical standards. The Group is a corporate member of the UK Institute of Business Ethics and the US Defense Industry Initiative.

#### Stakeholder engagement

The Group's principal stakeholders include investors, customers, employees, business partners, suppliers, civil society organisations and the communities in which it operates.

BAE Systems aims to communicate openly with stakeholders about its business. Two-way dialogue helps the Group to understand others' views and concerns, and provides an opportunity to explain the Group's approach.

#### Public policy and lobbying

The Lobbying and Political Support Policy sets out the standards to be followed by anyone engaged in lobbying or other political engagement on behalf of BAE Systems, including those from outside the business. The principles underpinning this policy are:

- BAE Systems engages in lobbying activities in the countries in which it operates in order to communicate with, and inform, legislators and government decision-makers on matters relating to the Company's business;
- anyone engaged in lobbying activities on behalf of BAE Systems conducts themselves in a way that conforms with the Company's standards of responsible business conduct; and
- BAE Systems does not make corporate contributions or donations to political parties.

#### Industrial participation

Industrial participation or offset is governed by the Group's Offset Policy which sets out the standards to be followed by anyone engaged in offset activity on behalf of BAE Systems.

Customers may use offset as a discriminator as part of their procurement process and a request for offset may impact on the Group's ability to access international markets. The underlying principles applicable to all of the Group's offset activities are that:

- they are undertaken in accordance with the Code of Conduct;
- they have clear line management ownership and executive oversight;
- they are consistent with the customer's offset policies and proportionate to the value of related contracts; and
- financial and non-financial risks are clearly assessed and mitigated.

#### Advisers

BAE Systems has rigorous standards concerning the appointment of advisers. All appointments must be proposed and approved in accordance with the Group's processes and require final authorisation through an external panel.

#### Human rights

The Group is committed to respecting human rights in its operations, within its sphere of influence.

#### Taxation

The Group seeks to build constructive working relationships with tax authorities while following a policy of open disclosure in order to achieve early agreement and certainty in relation to its tax affairs. Whilst the Group aims to maximise the tax efficiency of its business transactions, it does not use structures in its tax planning that are against the spirit of the law and actively considers the implications of any planning for the Group's wider corporate reputation. Further information on the Group's tax policies is set out on page 120.

^\* See Deloitte LLP assurance statement on page 119.



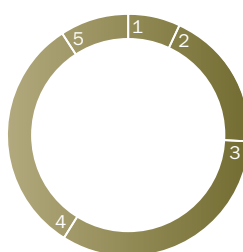
## 2013 gender diversity\* (%)

1	70	30
2	74	26
3	78	22
4	84	16
5	91	9
6	80	20

■ Male  
■ Female

1	Electronic Systems
2	Cyber & Intelligence
3	Platforms & Services (US)
4	Platforms & Services (UK)
5	Platforms & Services (International)
6	Total

## 2013 age diversity\* (%)



1	25 years and younger	7
2	26 – 35 years	19
3	36 – 49 years	33
4	50 – 59 years	32
5	60 years and older	9

## An inspired workforce

BAE Systems recognises that its employees are key to delivering the Group's strategy successfully and sustaining future business.

The Group serves the needs of its customers by delivering a wide range of advanced defence, aerospace and security solutions that provide a performance edge. With some 84,600 employees<sup>1</sup>, BAE Systems relies on talented people who are committed to delivering these solutions.

### People development

The Group's people strategy of through-career capability development and emphasis on high levels of employee engagement seeks to maximise the contribution that its workforce makes to the performance of the business.

The people strategy assists every member of the team to fulfil their personal potential. The success of this strategy is measured ultimately in the success of the business as a whole.

The Group continues to focus on the development of its current and future employees with structured global programmes linked to Total Performance Leadership, an integrated performance management and leadership development framework. In 2013, more than 360 leaders in the UK took part in the 'Leading for Total Performance' development programme, which has been designed to be the catalyst for a 'mind-set' shift in the Group's leadership population, supporting leaders to face the challenging and changing business climate with confidence and with the right skills to flourish. More than 720 leaders have participated in the programme since it started at the end of 2011.

The Group has continued to demonstrate its commitment to the continuous professional and personal development of its workforce. Development planning is supported by flexible training and education programmes that

encourage a culture of lifelong learning and help employees to develop their skills to maximise their potential.

In 2013, the Group continued to invest in learning programmes for all employees that support its culture of responsible business conduct. Extensive use is made of e-learning media, classroom training and partnerships with academic institutions to provide development and learning offerings. Over 200 courses are made available to employees and their families.

Sustaining and developing capability relies on developing the existing workforce and hiring talented people to meet current and future skills requirements.

### Employee engagement

The Group recognises the importance of engaging its employees to help them make their fullest contribution to the business. Through a variety of media, the Group's leadership seeks to listen to employees' views and opinions, and keep them informed about developments and prospects for the business. In 2013, there continued to be more frequent use of leadership blogs and other e-enabled communication channels.

In the fourth quarter of 2013, employees were invited to take part in an engagement survey. The overall participation rate compared with the previous engagement survey increased by 11 percentage points to 58%. Across BAE Systems, there were increases reported in the survey questions on engagement, creating an environment of openness and trust, and pride in working for BAE Systems. This reflects the Group's ongoing commitment to creating an environment in which employees can contribute to the success of the Group.

Regular internal communication, including e-Cards, newsletters, management and team meetings, monthly team briefs and the intranet, keeps employees informed, involved and inspired.

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

When redundancies have been necessary to align with customer requirements for products and services, management works with employees, trade unions, and local and national bodies to mitigate the impact on the people and communities affected.

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

### Diversity and inclusion

BAE Systems is committed to creating an inclusive work environment where a diverse range of talented people can work together to ensure business delivery. Diversity amongst the Group's workforce is a significant force for innovation and assists the Group in responding to customer requirements.

The Group focuses on its goal of building a diverse workforce which reflects that of the populations it recruits from. A particular current focus is increasing female representation in the pipeline for senior roles where this is possible.

A standard Management Resource Review, which includes succession and development planning, is conducted annually at Group and business level. The 2013 review showed that 20% of the high-potential population are female.

Across the Group, businesses have put in place plans to 2015 to support and progress this aim. Activities include a focus on succession planning, development and leadership programmes and mentoring initiatives.

In 2013, the Executive Committee progressed actions to grow the female talent pipeline at senior executive levels:

**Fostering a culture of inclusion** – unconscious bias training for all employees was rolled out

<sup>1</sup> Including share of equity accounted investments.

\* See Deloitte LLP assurance statement on page 119.

### Diversity and inclusion

In August, a group of employees in the UK became the first from a major engineering business to take part in the Manchester Pride parade. The Pride festival is an annual ten-day event for the lesbian, gay, bisexual and transgender community.



during 2013. The objective of the training is to enhance talent management by raising awareness of unconscious and conscious bias that can influence decisions.

**Accelerating the development of high-potential women** – an Executive Committee mentoring programme, launched during 2012 to leverage the readiness of high-potential women across the organisation, continued during 2013. Of the first cohort of 24 women, over 70% were promoted or moved roles. A second cohort was launched in November 2013.

**Increasing leadership diversity** – to ensure diverse candidate lists for leadership roles, where possible, executive search firms were employed with a track record of open and inclusive recruitment processes, and drawing from an appropriately diverse pool of candidates, with the overall aim of appointing the best person for the role. During 2013, the percentage of external female candidates hired was 26%.

**Measuring performance** – on a national basis, defined aspirational objectives and actions have been put in place to increase gender diversity. Gender diversity in leadership positions and succession plans is monitored.

At the end of 2013, three (27%) and two (17%) of the Board and Executive Committee members, respectively, were women. Globally, 59 (15%) and 15,000<sup>1</sup> (20%) of the Group's senior managers<sup>2</sup> and total workforce are women, respectively.

BAE Systems is proud to have received recognition for the progress it is making on diversity. The Group regularly benchmarks itself against external organisations and uses expert groups to provide inputs to diversity programmes.

Achievements during 2013 included:

- BAE Systems India's programme to support women employees to develop their careers was recognised as best practice by the National Human Resource Development Network, a national level association of human resources professionals.
- In the UK, BAE Systems was awarded the Large Companies award at the Mail on Sunday's 'Breaking the Mould' awards for its work in providing opportunities for women at all levels of the UK business and "attracting and retaining women to an engineering company".
- For the seventh consecutive year, BAE Systems was listed in the top 50 UK companies in which women want to work by The Times newspaper.
- BAE Systems won an Opportunity Now Excellence In Practice Award. The 'Inspiring the Workforce of the Future' award was presented for the innovative work BAE Systems does in providing opportunities for female apprentices.

The Group is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Group.

#### Education and early careers

The Group works with the education sectors in each of its home markets to help shape the workforce of the future with a particular emphasis on encouraging young people to pursue careers in science, technology, engineering and mathematics.

In the US, BAE Systems is partnering with several organisations, such as the National Math and Science Initiative and the Aerospace Industries Association, to support the development of science, technology, engineering and mathematics curricula and engage young students, with the goal of inspiring them to become future engineers. For example, the business supports organisations such as Team America Rocketry Challenge.

In the UK, the Group has again teamed with the Royal Air Force in staging a Schools Road Show, taking a theatre-based class to over 250 schools, engaging 25,000 pupils in 2013 about careers in engineering.

In 2013, BAE Systems Saudi Arabia graduated 30 students from its annual Summer Training Programme which provides key training in business, computer and interpersonal communication skills. More than 500 students from various universities, colleges and schools join the programme annually.

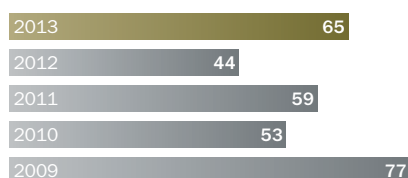
In Australia, the business sponsors school pupils to participate in the FIRST (Foundation for Inspiration and Recognition of Science and Technology) LEGO League and FIRST Robotics Competition, both aimed at encouraging more young people to engage in science, technology, engineering and mathematics.

In India, BAE Systems has a long-term partnership agreement with Smile Foundation, a national level development organisation with an outreach of over 200,000 underprivileged children, women and youth across 25 states. In 2013, BAE Systems launched a mobile hospital called 'Smile on Wheels' that provides primary healthcare services to underserved communities in the city of Bengaluru in India.

<sup>1</sup> Excluding equity accounted investments and rounded to the nearest thousand employees.

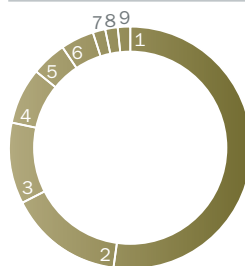
<sup>2</sup> Senior managers are defined as employees who have responsibility for planning, directing or controlling the activities of the Group or a strategically significant part of the Group and/or who are directors of subsidiary undertakings.

## Major injuries recorded\*



Major injuries recorded increased during 2013 prompting detailed reviews and investigation by senior management.

## 2013 causes of major injuries recorded\* (%)



1	Slips, trips or falls on same level	34
2	Struck by moving/falling object	10
3	Injured while handling, lifting or carrying	7
4	Fall from height	5
5	Strike against something fixed/stationary	3
6	Contact with moving machinery	3
7	Trapped by something collapsing/overturning	1
8	Contact with fire	1
9	Struck by moving vehicle	1

## Minimum wage

BAE Systems complies fully with its obligations under minimum wage regulations.

## Employee safety

Safety of the Group's employees, and anybody who works on its sites, is a key priority. The Group continues to embed a safety first approach by providing training and tools that help employees understand the importance of a safe workplace, and encouraging employees to take responsibility for their own safety and the safety of those around them. The senior leadership of the Group plays a key role in maintaining the focus on safety and leading through example.

During 2013, the Group's global Safety, Health and Environment (SHE) Steering Group focused on reviewing high-risk manufacturing activities which could lead to major accidents. The SHE Steering Group also monitored safety performance, including progress against the Safety Maturity Matrix (SMM), which was introduced in 2008. The SMM has helped drive consistent standards of safety across the Group.

The metric used by the Group to measure workplace injuries is the Recordable Accident Rate which, along with the number of major accidents, is used to determine an element of executive bonus. During 2013, the Recordable Accident Rate\* decreased by 17%, ahead of improvement targets set. This progress represents a sixth consecutive year of improvement. The number of major injuries increased compared with 2012 prompting detailed reviews and investigation by senior management. The chart above shows that over half of the major injuries in 2013 were due to slips, trips or falls.

Regrettably, there were two work-related employee fatalities in 2013. Each accident is thoroughly investigated and lessons learnt are applied across the Group.

## Employee health and wellbeing

The Group recognises that a healthy workforce is a more engaged and productive one and, during 2013, promoted an enterprise-wide campaign to make employee wellbeing a top priority.

In the US, thousands of employees embraced a new 'wellness challenge' through the BAE Systems, Inc. Health Council's 'Be ProActive' initiative, which gives access to programmes, tools and resources to help them take charge of their health.

A UK-wide working group has introduced a new Employee Assistance Programme (EAP), produced a common suite of occupational health standards and processes, co-ordinated UK-wide health and lifestyle promotions and awareness campaigns, and re-tendered and consolidated all third-party occupational health service provision across the Group's UK sites.

The EAP, launched in 2012, is a confidential service available 24 hours a day, 365 days a year. It provides counsellors and legal and medical advisers who offer confidential advice on topics such as personal finances, relationships, bereavement, stress and anxiety. The EAP service had over 11,000 interactions with employees in 2013, including telephone and face-to-face counselling, calls to the telephone advice helpline and use of the online health portal.

In Australia, BAE Systems offers health awareness programmes, including the 'Weightwatchers @ Work' programme, which encourages healthy eating and lifestyle choices.

## Responsible environmental management

## Operational

The Group's primary operational impacts on the environment are through the use of energy used for heating and lighting workspaces. The Group has relatively few energy-intensive processes. Water use is also linked to employee numbers apart from in the Munitions business (steam and cooling) and shipyards where water use fluctuates significantly if a dry dock is used. In the majority of businesses, waste is of high value and they seek to recycle wherever possible.

The Group's goal is to reduce the environmental impact of its operations and products by using energy, water and waste more efficiently.

Businesses across the Group have environmental management systems in place that monitor and manage impacts from greenhouse gas emissions, material and solvent use, waste products and emissions to the atmosphere.

During 2013, businesses set targets to reduce the amount of energy and water used, and the amount of waste generated. In total during the year, energy use reduced by 7%<sup>1</sup>, water consumption reduced by 16%<sup>2</sup> and waste generated reduced by 17%<sup>2</sup>.

The majority of the Group's greenhouse gas emissions come from energy use and business travel.

Whilst the business has achieved a reduction in energy use on a like-for-like basis, the Group's reported carbon footprint<sup>3</sup> for 2013 has increased by 31%. This is the result of an increasingly mature approach to capturing emissions data across the global business. The carbon footprint<sup>3</sup> now includes some

1 Data is derived from internal recording systems on a like-for-like basis with 2012 and is not subject to external verification or audit.

2 Data is derived from internal recording systems and is not subject to external verification or audit.

3 The footprint was externally compiled by the Coefficient Company.

4 Excluding share of joint ventures.

\* See Deloitte LLP assurance statement on page 119.

Energy usage<sup>1</sup>**-7%**Water consumption<sup>2</sup>**-16%**Waste generated<sup>2</sup>**-17%**
**Global greenhouse gas emissions data for the period 1 November 2012 to 31 October 2013 (tonnes of CO<sub>2</sub>e)<sup>†</sup>**

1	535,370
2	679,750
3	243,710

**Emissions per employee<sup>4</sup>** **19**

- 1 Combustion of fuel and operation of facilities (Scope 1)
- 2 Electricity, heat, steam and cooling purchased for own use (Scope 2)
- 3 Business travel (Scope 3)

<sup>†</sup>The sources of greenhouse gas emissions fall within the Group's consolidated financial statements. Emissions from joint ventures and pension scheme properties not occupied by the Group are not included.

The greenhouse gas emissions data is in line with the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised version) and emission factors for fuels and electricity from the 2013 Government GHG Conversion Factors for Company Reporting.

The CO<sub>2</sub>e associated with carbon dioxide, methane and nitrous oxide is reported. Greenhouse gas emissions associated with hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride are estimated to be immaterial to total emissions.

The reporting year for greenhouse gas emissions is offset from the financial reporting year. The Australian carbon data included relates to the most recent reporting year for the National Greenhouse and Energy Reporting Scheme regulations ended June 2013.

The principal record of the Group's worldwide facilities is its legal department's Global Property Database.

Greenhouse gas emissions are primarily calculated from energy consumption records reported via the Group's global environmental database. Where actual usage data is not available for facilities and residences within the Global Property Database, an estimated consumption is used based on floor areas and usage type.

Greenhouse gas emissions related to business travel include air travel data for the majority of the global business, hire car and rail data for business units operating in the UK and US, and executive car data and hotel bookings for businesses in the UK only. These data are taken from suppliers' procurement records.

significant additional sites and fuel sources not present in the 2012 calculation. The 2013 footprint<sup>3</sup> also incorporates changes to CO<sub>2</sub>e conversion factors that increase reported emissions from certain business activities.

**Product**

Environmental considerations are taken into account throughout a product's lifecycle from concept, design and manufacture through to use and disposal via the Group's Lifecycle Management (LCM) process (see page 69). This includes reducing the environmental impacts of the Group's products during research and development, minimising waste materials during manufacturing, and helping to reduce the impact of our products when they are used, upgraded or disposed of.

Engineers are given training and guidance via the Group-wide Environmental Policy and Product Environmental Management handbook to promote understanding of environmental product design.

The Group works with suppliers to reduce the environmental impact of the products and services they supply, reducing costs and the Group's environmental footprint. To support this, the Group has a Sustainable Procurement handbook to help purchasing teams understand and embed environmental standards into the supplier management process.

Working in partnership with a variety of organisations, the Group helps improve the environmental impacts of its business and the wider defence industry. BAE Systems is a corporate member of the Institute of Environmental Management and Assessment (IEMA). In the UK, this is used to develop the competencies of both environmental and non-environmental specialists. Elsewhere, BAE Systems is working with IEMA on the up-skilling and professional development of individuals across the environmental arena.

The Group monitors and reports greenhouse gas emissions, primarily from energy use, on a Group-wide basis. This supports the Group in meeting the requirements of legislation, such as the UK government's Carbon

Reduction Commitment and the Australian National Greenhouse and Energy Reporting Act.

**Product stewardship**
**Innovation**

Innovation is both BAE Systems' heritage and key to the sustainability of the Group in meeting the rapidly changing and diverse military and civil requirements of customers.

The Group's Research & Development (R&D) activities cover a wide range of programmes, and include technological innovations and techniques to improve the manufacturing and service of products. In 2013, R&D expenditure was £1,051m (2012 £1,138m) of which £171m (2012 £150m) was funded by the Group.

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

Like any industrial concern, BAE Systems, in producing products and providing services, creates intellectual property which often has a value to the Group far greater than is reflected in the value of the particular contract or programme of work. It takes many forms, including products, processes and know-how.

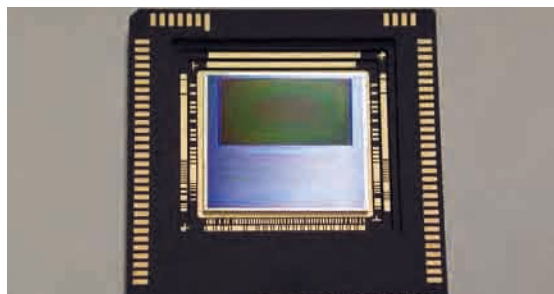
The Group's Operational Framework mandates a policy to protect the Group's intellectual property (including patents, registered designs, and registered trade and service marks) through appropriate use and observance of intellectual property law, so that returns made from the investment in research and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

In 2013, the Group filed patent applications covering approximately 250 new inventions. At 31 December 2013, BAE Systems had a total portfolio of patents and patent applications covering more than 2,000 inventions internationally.



**Innovation – information at your fingertips**

Pilots of the Hawk Advanced Jet Trainer aircraft will have vital information at their fingertips thanks to new tablet computers fitted by BAE Systems. The computers allow training pilots to view everything from technical publications, landing trajectories, conversion applications and weather forecasts at the tap of a touch-screen.

**Innovation – ultra low noise CMOS imaging**

The Complementary Metal Oxide Semiconductor (CMOS) image sensor has brought the world of shadows into sharp focus and is a solution that brings together wide dynamic range, high speed, low noise, wide field of view and increased sensitivity in a single innovation.

**Product integrity**

It is critical that the Group's products perform as designed without harm to the people using them. No complex and innovative product, whether used in defence or civilian markets or both, is without risk. It is essential that the Group achieves an appropriate balance between the benefits they provide to customers and the risks associated with their use.

The Group's Product Safety Policy is principles-based (Accountability; Level of Safety; Conforming Products; and Learning and Sharing Information) and these principles apply throughout a product's life from design and manufacture through use to disposal. It is recognised that some product responsibilities may extend beyond the contractual life of customer contracts.

The safety of the Group's products relies on the considered application of its Product Safety Policy, adherence to the Product Safety Management Systems, and the responsible attitudes and behaviours of the many individuals who are alert to the safety implications of their own actions and those of others.

Across the Group's businesses, there are a number of working groups that consider product safety issues, different approaches (which reflect the different legal and regulatory environments in which the Group operates), research, best practice and knowledge sharing. These working groups continue to inform the Group's approach to product safety.

Management of product safety risks remained a focus during 2013. The Group continues to work with its customers to agree the level of safety required that is both ethical and lawful. The Group aims to ensure that accountabilities are clearly defined and that it delivers conforming products. The businesses continued to learn and share information on product safety-related matters, both internally and externally to the Group.

**Adherence to international conventions**

BAE Systems plc and its subsidiaries are compliant with the global conventions, Oslo and Ottawa, on cluster munitions and anti-personnel devices, respectively. The Group does not manufacture biological or chemical weapons, or those containing white phosphorous or depleted uranium.

**Unmanned Autonomous Systems**

BAE Systems has developed and continues to develop a number of autonomous systems which are under the control of highly-trained human operators at all times.

Autonomous systems can access terrain and atmospheric situations inaccessible to humans.

Autonomous surveillance systems are designed to flag abnormal or criminal patterns of behaviour – highly important in identifying threats from terrorists or suicide bombers.

BAE Systems' Taranis unmanned aircraft has integrated stealth technologies, propulsion systems and advanced mission systems, all of which are relevant to the next generation of military aerospace capabilities. Taranis was designed to demonstrate the Group's ability to create a system capable of undertaking sustained surveillance, marking targets, gathering intelligence and carrying out strikes in hostile territory.

**Managing the supply chain**

Robust and effective supplier management is critical to the Group to help to deliver the products and systems its customers need, on time and to the quality they expect. Poor performance or unethical conduct by a supplier could affect the Group's reputation or its ability to operate effectively.

The Group requires its suppliers to comply with local legislation and to apply standards on issues such as ethical conduct, health and safety, environment, civil liberties and human rights that are equivalent to those mandated across BAE Systems. The Group also requires them to have an ethical Code of Conduct for Responsible Trading of similar standard to its own, and to apply these standards in their own supply chains. Compliance to required standards is evaluated during the supplier selection process, and for existing suppliers as part of ongoing quality and approvals assurance.

**Supplier payment policy**

It is Group policy that suppliers should be paid in accordance with the payment terms and conditions stated in the applicable purchase order. In the UK, the Group is a signatory to the government's Prompt Payment Code (see [www.promptpaymentcode.org.uk](http://www.promptpaymentcode.org.uk)), under which it has undertaken to pay suppliers on time, give clear guidance on payment procedures and encourage the adoption of the code throughout its supply chain. The average number of days' credit provided in 2013 by suppliers was 27 days (2012 30 days).

**Responsible trading characteristics for procurement**

Assessing major suppliers for their potential responsible trading risk is a key part of the Group's procurement processes and this extends from initial market analysis and sourcing, through to tendering, supplier selection and contract award. This becomes particularly important for suppliers of products to projects of significant value and/or those suppliers which are critical to the delivery of a programme.



### Environment – fuel efficiency

The BAE Systems Ship Energy Assessment System (SEAS) enables ship operators to save fuel by dynamically tracking the fuel performance profile of a ship. SEAS builds and maintains performance trends, allowing the crew to predict and manage fuel consumption, optimise efficiency and reduce operating cost.

The product has been successfully trialled at sea by the Royal Navy, demonstrating up to a 28% fuel saving, where it continues to support current operations.

### Environment – saving water

Severe drought and a 68% empty water reservoir in central Texas, US, prompted the facilities team in Austin to seek innovative ways to conserve potable water. Working with the City of Austin, BAE Systems piped reclaimed sewage water to its chiller plants for use in the plant's cooling towers, which is expected to cut the business' annual utility expenses by \$65,000 by saving an estimated ten million gallons of potable water a year.



To facilitate such an assessment, BAE Systems has created a set of Responsible Trading Characteristics for Procurement. These characteristics are captured in six questions which should be asked throughout the procurement lifecycle.

1. Do the major suppliers have a code of conduct or responsible trading policy of a comparable standard to BAE Systems?
2. Does the product or service being procured create a significant lasting adverse environmental or health impact over and above that reasonably necessary in its manufacture, storage, deployment, use or disposal?
3. Does the product or service being procured conform to BAE Systems' Product Safety Policy?
4. Is the product or service being procured subject to export control, and if so, are the appropriate clearances or licences in place or planned?
5. Is it likely that the production of this product or service will violate civil liberties or human rights?
6. Is the product being procured likely to be controlled or prohibited by legislation in the foreseeable future?

### Community investment

BAE Systems is committed to effecting change. This commitment is demonstrated through work with local and national organisations with an objective to make a difference in the communities in which the Group operates. BAE Systems' Global Community Investment Strategy is defined through the support it provides both financial and through volunteering. BAE Systems aims to align its resources in support of primary areas of focus – the needs of the Group's customers, education and skills, heritage and the communities in which the Group operates.

As BAE Systems is a global company, each of its key markets has also created its own strategy in support of the Global Community Investment Strategy which is relevant to specific local issues, charitable needs and culture.

#### Charitable contributions

Globally, the Group and its employees through the Community Investment programme contributed over £10m\* during 2013 to local, national and international charities and not-for-profit organisations, including:

- £1.0m given to the UK Defence and National Rehabilitation Centre;
- £4.5m given to armed forces charities, including Soldiers, Sailors, Airmen and Families Association (SSAFA), the Royal Navy and Royal Marines Charity and the United Service Organizations (USO); and
- £2.5m donated to education charities and programmes, including:
  - the Queen Elizabeth Prize for Engineering and The Prince's Trust in the UK;
  - the National Math and Science Initiative in the US; and
  - FIRST (Foundation for Inspiration and Recognition of Science and Technology) in Australia.

### Deloitte LLP assurance statement

This year, Deloitte LLP assured the following performance indicators at Group level:

**Ethics and governance** – employee and third-party enquiries to Ethics Helpline<sup>^</sup> (total number and number by category) and dismissals for reasons relating to unethical behaviour\*;

**Safety** – Recordable Accident Rate\*, the number of major injuries recorded\* and causes of major injuries recorded\*;

**Diversity and inclusion** – employees split by gender\* and age\*; and

**Community** – total Community Investment programme donations\*.

Deloitte LLP has provided limited assurance on performance indicators marked with a \* and reasonable assurance on performance indicators marked with a ^.

To see Deloitte LLP's unqualified assurance statement go to: [www.baesystems.com/deloitteassurancestatement](http://www.baesystems.com/deloitteassurancestatement)

To see the Group's basis of reporting 2013 go to: [www.baesystems.com/2013crdata](http://www.baesystems.com/2013crdata)

# OTHER STATUTORY AND REGULATORY INFORMATION

## Company registration

BAE Systems plc is registered in England and Wales with the registered number 1470151.

## Directors

The current directors who served during the 2013 financial year are listed on pages 67 and 68. Of those directors, Ian Tyler was appointed to the Board on 8 May 2013, Chris Grigg on 1 July 2013 and Sir Roger Carr on 1 October 2013. Sir Peter Mason and Lee McIntire served as directors during the period, with Sir Peter Mason retiring from the Board on 8 May 2013 and Lee McIntire resigning from the Board on 20 August 2013. Sir Richard Olver and Linda Hudson also served as directors during the period until their retirement from the Board on 1 February 2014. In addition, Jerry DeMuro joined the Board on 1 February 2014.

## Dividend

An interim dividend of 8.0p per share was paid on 2 December 2013. The directors propose a final dividend of 12.1p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 2 June 2014 to shareholders on the share register on 22 April 2014.

## Annual General Meeting (AGM)

The Company's AGM will be held on 7 May 2014. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

## Certain information in the Strategic Report

Particulars of important events affecting the Group which have occurred since 31 December 2013 and an indication of likely future developments in the business of the Group are set out in the Strategic Report on pages 6 to 65.

## Office of Fair Trading undertakings

As a consequence of the merger between British Aerospace and the former Marconi Electronic 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.

## Profit forecast

In its half-year results announcement on 1 August 2013, the Group made the following statement, which is regarded as a profit forecast for the purposes of the Financial Services Authority's Listing Rule 9.2.18 (and which replaced the profit forecast made in the Group's full-year results announcement on 21 February 2013 and in the Annual Report 2012):

"In aggregate, including both the benefit from the share repurchase programme and downside arising from reductions to US defence budgets, double-digit growth in underlying earnings per share is anticipated for 2013. This outlook assumes the satisfactory conclusion to Salam pricing negotiations this year."

Underlying earnings per share was 38.7p in 2012 as re-presented on classification of the Regional Aircraft line of business as a continuing operation and restated on adoption of the revised International Accounting Standard 19, Employee Benefits. In 2013, underlying earnings per share was 42.0p.

## Financial instruments

The Group uses financial instruments for risk management purposes. The Group's objectives and policies relating to financial risk management are summarised below and set out in more detail in note 28 to the Group accounts on pages 175 and 176.

### Interest rate risk

The Group's objective is to manage its exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, mainly interest rate swaps.

### Liquidity risk

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

### Credit risk

The Group's objective is to monitor and control counterparty credit risk and credit limit utilisation. The Group adopts a conservative approach to the investment of its surplus cash.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue.

### Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

## Taxation

The Group's tax strategy is to:

- ensure compliance with all applicable tax laws and regulations; and
- manage the Group's tax expense in a way that is consistent with its values and its legal obligations in all relevant jurisdictions.

The Group seeks to build constructive working relationships with tax authorities while following a policy of open disclosure in order to achieve early agreement and certainty in relation to its tax affairs. Whilst the Group aims to maximise the tax efficiency of its business transactions, it does not use structures in its tax planning that are against the spirit of the law and actively considers the implications of any planning for the Group's wider corporate reputation. Arm's length principles are applied in the pricing of all intra-group transactions of goods and services in accordance with Organisation for Economic Co-operation and Development guidelines. Where appropriate, the Group engages with governments to help shape proposed legislation and tax policy. The Group endorses the statement of tax principles issued by the Confederation of British Industry in May 2013 ([http://www.cbi.org.uk/media/2051390/statement\\_of\\_principles.pdf](http://www.cbi.org.uk/media/2051390/statement_of_principles.pdf)).

BAE Systems operates internationally and is subject to tax in many different jurisdictions. The Group employs professional tax managers and takes appropriate advice from reputable professional firms. The Group is routinely subject to tax audits and reviews which can take a considerable period of time to conclude. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The assessment and management of tax risks are regularly reviewed by the Audit Committee.

## Political donations

No political donations were made in 2013.

## Issued share capital

As at 31 December 2013, BAE Systems' issued share capital of £88,404,817 comprised 3,536,192,674 ordinary shares of 2.5p each and one Special Share of £1.

## Share buyback

During the year, 51,595,000 ordinary shares of 2.5p each were repurchased under the buyback programme announced on 21 February 2013 and such repurchased shares have been cancelled. The total consideration for the purchase of the shares, including commission and stamp duty, was £212,359,150.



### Treasury shares

As at 1 January 2013, the number of shares held in treasury totalled 336,813,996 (having a total nominal value of £8,420,350 and representing 9.4% of the Company's called up share capital at 1 January 2013). During 2013, the Company used 9,169,044 treasury shares (having a total nominal value of £229,226 and representing 0.3% of the Company's called up share capital at 31 December 2013) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (5,337,173 shares in aggregate), awards vested under the Performance Share Plan (364,445 shares) and the Restricted Share Plan (1,809,975 shares), and options exercised under the Executive Share Option Plan (1,657,451 shares). The treasury shares utilised in respect of the Share Incentive Plan, the Performance Share Plan and the Restricted Share Plan were disposed of by the Company for nil consideration. The 1,657,451 shares disposed of by the Company in respect of the Executive Share Option Plan were disposed of by the Company for an aggregate consideration of £3,928,802. As at 31 December 2013, the number of shares held in treasury totalled 327,644,952 (having a total nominal value of £8,191,124 and representing 9.3% of the Company's called up share capital at 31 December 2013).

The rights to treasury shares are restricted in accordance with the Companies Act and, in particular, the voting rights attaching to these shares are automatically suspended.

### Rights and obligations of ordinary shares

On a show of hands at a general meeting every holder of ordinary shares present in person and entitled to vote shall have one vote, and every proxy entitled to vote shall have one vote (unless the proxy is appointed by more than one member in which case the proxy has one vote for and one vote against if the proxy has been instructed by one or more members to vote for the resolution and by one or more members to vote against the resolution; or if the proxy has been instructed by one or more shareholders to vote either for or against a resolution and by one or more of those shareholders to use his discretion how to vote). On a poll, every member present in person or by proxy and entitled to vote shall have one vote for every ordinary share held. Subject to the relevant statutory provisions and the Company's Articles of Association, holders of ordinary shares are entitled to a dividend where declared or paid out of profits available for such purposes. Subject to the relevant statutory provisions and the

Company's Articles of Association, on a return of capital on a winding-up, holders of ordinary shares are entitled, after repayment of the £1 Special Share, to participate in such a return. There are no redemption rights in relation to the ordinary shares.

### Rights and obligations of the Special Share

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

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

The holder of the Special Share has the right to require 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 19 February 2014, the Company had been advised of the following significant direct and indirect interests in the issued ordinary share capital of the Company:

Name of shareholder	Percentage notified
AXA S.A. and its group of companies	5.00%
Barclays PLC	3.98%
The Capital Group Companies, Inc.	4.06%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	13.02%
Silchester International Investors LLP	3.01%

### Exercise of rights of shares in employee share schemes

The Trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

### Restrictions on voting deadlines

The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

### Appointment and replacement of directors

Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The majority of directors holding office must be British. Otherwise, the directors who are not British shall vacate office in such order that those who have been in office for the shortest period since their appointment shall vacate their office first, unless all of the directors otherwise agree among themselves. Any director who holds the office of either Chairman (in an executive capacity) or Chief Executive shall also be British.

The Company must have six directors holding office at all times. If the number is reduced to below six, then such number of persons shall be appointed as directors as soon as is reasonably practicable to reinstate the number of directors to six. The Company

may by ordinary resolution from time to time vary the minimum number of directors.

At each AGM of the Company, any director who was elected or last re-elected at or before the AGM held in the third calendar year before the then current calendar year must retire by rotation and such further directors must retire by rotation so that in total one-third of the directors retire by rotation each year. A retiring director is eligible for re-election. It is the Board's intention that all directors will stand for election or re-election in 2014 in compliance with the UK Corporate Governance Code.

### Amendment of the Company's Articles of Association

The Company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders. Where class rights are varied, such amendments must be approved by the members of each class of shares separately.

In addition, certain provisions of the Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British.

### Powers of the directors

The directors are responsible for the management of the business of the Company and may exercise all powers of the Company subject to applicable legislation and regulation, and the Articles of Association.

At the 2013 AGM, the directors were given the power to buy back a maximum number of 324,606,396 ordinary shares at a minimum price of 2.5p each. The maximum price was the higher of (i) an amount equal to 105% of the average of the middle market quotations of the Company's ordinary shares as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the day on which such ordinary shares are contracted to be purchased, and (ii) the higher of the price of the last independent trade and the highest current independent bid on the London Stock Exchange as stipulated in Article 5(1) of the Buy-back and Stabilisation Regulation. This power will expire at the earlier of the conclusion of the 2014 AGM or 30 June

2014. A special resolution will be proposed at the 2014 AGM to renew the Company's authority to acquire its own shares.

At the 2013 AGM, the directors were given the power to issue new shares up to a nominal amount of £27,047,828. This power will expire on the earlier of the conclusion of the 2014 AGM or 30 June 2014. Accordingly, a resolution will be proposed at the 2014 AGM to renew the Company's authority to issue further new shares. At the 2013 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £27,047,828 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2014 AGM or 30 June 2014, and a resolution will be proposed at the 2014 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 2013 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' Report.

### Change of control – significant agreements

The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

- The Group has entered into a £2bn Revolving Credit Facility dated 12 December 2013 which provides 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 facility. The Revolving Credit Facility was undrawn as at 31 December 2013.
- The Company has entered into a Restated and Amended Shareholders Agreement with European Aeronautic Defence and Space Company EADS N.V. (EADS) and Finmeccanica S.p.A. (Finmeccanica) relating to MBDA S.A.S. dated 18 December 2001 (as amended). In the event that control of the Company passes to certain specified third-party acquirors, the agreement allows EADS and Finmeccanica to exercise an option to terminate certain executive management level nomination and voting rights, and certain shareholder information rights of the Company in relation to the MBDA joint venture. Following the exercise of this option, the Company would have the right to require the other shareholders to purchase its interest in MBDA at fair market value.

The Company and EADS have agreed that if Finmeccanica acquires a controlling interest in the Company, EADS will increase its shareholding in MBDA to 50% by purchasing the appropriate number of shares in MBDA at fair market value.

- The Company, BAE Systems, Inc., BAE Systems (Holdings) Limited and BAE Systems Holdings Inc. entered into a Special Security Agreement dated 8 November 2010 with the US Department of Defense regarding the management of BAE Systems, Inc. in order to comply with the US government's national security requirements. In the event of a change of control of the Company, the Agreement may be terminated or altered by the US Department of Defense.
  - In July 2009, BVT Surface Fleet Limited (now BAE Systems Surface Ships Limited) and the UK Ministry of Defence (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 of control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. In the event that there is a change of 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.
- On 6 November 2013, BAE Systems and the MoD entered into a non-binding Commercial Principles Agreement which set out a programme for the entering into of future contracts which would result in the progressive amendment and termination of the ToBA. These future contracts have not yet been entered into.
- In August 2008, BAE Systems Land Systems (Munitions & Ordnance) Limited (now BAE Systems Global Combat Systems Munitions Limited) and the UK MoD entered into a 15-year partnering agreement for the provision of ammunition to UK Forces (the Munitions Acquisition Supply Solution (MASS) partnering agreement). Where the UK MoD considers that a proposed change of control of BAE Systems Global Combat

Systems Munitions Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the UK MoD is established. In the event that there is a change of control of BAE Systems Global Combat Systems Munitions Limited, notwithstanding the objection of the UK MoD on such grounds, the UK MoD may, having followed the dispute resolution process, terminate the MASS agreement for default.

- In November 2012, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 4 of the Astute Class programme (the 'Agreement'). Where the MoD considers that a proposed change of control of BAE Systems Marine Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement is established with the MoD. In the event that there is a change of control of BAE Systems Marine Limited, notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the Agreement immediately.

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 LLP have indicated their willingness to be appointed as the auditors for the Company and a resolution proposing their appointment will be put to the AGM.

### Statement of directors' responsibilities in respect of the Annual Report and financial statements

The directors are responsible for preparing the Annual Report, and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law, and have elected to prepare the parent company financial statements in accordance with UK accounting standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company, and of their profit or loss for that period. In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions, and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group, and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a strategic report, directors' report, directors' remuneration report and corporate governance statement that comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

#### Statement of disclosure of information to auditors

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he/she ought to have taken to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

On behalf of the Board

**David Parkes**, Company Secretary  
19 February 2014

#### 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 Strategic Report and Directors' Report, taken together, include 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.

In addition, each of the directors considers that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

Sir Roger Carr	Chairman
Ian King	Chief Executive
Jerry DeMuro	President and Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Paul Anderson	Non-executive director
Harriet Green	Non-executive director
Chris Grigg	Non-executive director
Paula Rosput Reynolds	Non-executive director
Nick Rose	Non-executive director
Carl Symon	Non-executive director
Ian Tyler	Non-executive director

On behalf of the Board

**Sir Roger Carr**, Chairman  
19 February 2014

## FINANCIAL STATEMENTS

**Accounting policies**

Within the Group accounts, the accounting policies are included within the relevant note.



# Group accounts

## 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 70, and in accordance with EU-endorsed International Financial Reporting Standards (IFRS) 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).

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 income statement.

### Principal accounting policies

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

Certain of the Group's principal accounting policies are considered by the directors to be critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements. The directors believe that the consolidated financial statements reflect appropriate judgements and estimates, and provide a true and fair view of the Group's financial performance and position. The critical accounting policies are listed below and explained in more detail in the relevant notes to the Group accounts.

Critical accounting policy	Description	Notes
<b>Revenue and profit recognition</b>		1
– The recognition of revenue and profit on long-term contracts.	<p>The majority of long-term contracts are accounted for under IAS 11, Construction Contracts. Revenue on long-term contracts is recognised when performance milestones have been completed.</p> <p>The ultimate profitability of long-term contracts is estimated based on estimates of revenue and costs, including allowances for technical and other risks, which are reliant on the knowledge and experience of the Group's project managers, engineers, and finance and commercial professionals. Material changes in these estimates could affect the profitability of individual contracts.</p> <p>Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances.</p> <p>Profit is recognised progressively as risks have been mitigated or retired.</p>	
<b>Valuation of retirement benefit obligations</b>		23
– The determination of assumptions underpinning the valuation of retirement benefit obligations for defined benefit pension schemes; and	<p>Pension scheme accounting valuations are prepared by independent actuaries. For each of the actuarial assumptions used to measure the Group's pension scheme liabilities, there is a range of possible values and management exercises judgement in deciding 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.</p>	
– the determination of the share of the pension deficit allocated to the Group's equity accounted investments and other participating employers.	<p>The Group has allocated a share of the pension deficit to its equity accounted investments and other participating employers using a consistent allocation method intended to reflect a reasonable approximation of their share of the deficit.</p>	
<b>Carrying value of intangible assets</b>		11
– The valuation of acquired intangible assets; and	<p>Acquired intangible assets, excluding goodwill, are valued in line with internationally used models, which require the use of estimates that may differ from actual outcomes. These assets are amortised over their estimated useful lives. Future results are impacted by the amortisation periods adopted and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.</p>	
– the determination of assumptions underpinning goodwill impairment testing.	<p>Goodwill is not amortised, but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review calculations require the use of estimates related to the future profitability and cash-generating ability of the acquired businesses and the pre-tax discount rate used in discounting these projected cash flows.</p>	

### Changes in accounting policies

With effect from 1 January 2013, the Group has adopted the following amendment to an existing standard and new standard:

- **International Accounting Standard (IAS) 19 (revised 2011), Employee Benefits**, replaces interest cost on gross pension liabilities and expected return on gross pension assets with a finance cost on the net pension deficit calculated using the rate currently used to discount defined benefit pension liabilities. The discount rate is lower than the expected return on plan assets, increasing finance costs recognised in the income statement and correspondingly reducing remeasurements recognised in other comprehensive income. In addition, certain costs associated with the administration of the Group's pension schemes are now reported within operating costs rather than finance costs. The net pension deficit is not affected by these changes.

## Preparation (continued)

These changes have been applied retrospectively to the comparative financial information for 2012 and have had the following impact on the financial statements compared with the previous version of IAS 19:

	2013 £m	2012 £m
Operating costs	(34)	(39)
Share of results of equity accounted investments	(2)	(2)
<b>Operating profit</b>	<b>(36)</b>	(41)
Finance costs	(166)	(132)
<b>Profit before taxation</b>	<b>(202)</b>	(173)
Taxation expense	61	53
<b>Net decrease in profit for the year</b>	<b>(141)</b>	(120)
Remeasurements on defined benefit pension schemes	203	174
Tax on items that will not be reclassified to the income statement	(62)	(54)
<b>Total comprehensive income for the year</b>	<b>–</b>	–
<b>Earnings per share</b>		
Basic earnings per share	(4.4)p	(3.7)p
Diluted earnings per share	(4.3)p	(3.7)p
<b>Underlying earnings<sup>1</sup> per share</b>		
Underlying earnings <sup>1</sup> per share	(0.2)p	(0.4)p

The reduction in underlying earnings<sup>1</sup> per share mainly reflects the reclassification of certain costs associated with the administration of the Group's pension schemes from finance movements on pensions, which are excluded from underlying earnings<sup>1</sup>, to underlying EBITA<sup>2</sup>. In addition, during 2013, longevity swap arrangements were entered into by the trustees of certain UK schemes (see page 163). Under the revised IAS 19, these swaps are required to be valued in accordance with IFRS 13, Fair Value Measurement. The valuation under the previous version of IAS 19 would have reduced total comprehensive income for the year by £177m.

1 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8).

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

– **IFRS 13** aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement disclosure requirements for use across other standards within IFRSs. IFRS 13 does not extend the use of fair value accounting and has not impacted the fair value measurements carried out by the Group other than in relation to longevity swaps as above. IFRS 13 requires specific disclosures on fair values, which are provided in the relevant notes to the Group accounts.

A number of new EU-endorsed standards and amendments to existing standards, which are listed below, are effective for periods beginning on or after 1 January 2014 and have not been applied in preparing these consolidated financial statements. With the exception of new disclosure requirements, none of these are expected to have an impact on the consolidated financial statements of the Group and as such they have not been early adopted.

New standards and amendments to existing standards	Effective for periods beginning on or after
IFRS 10, Consolidated Financial Statements	1 January 2014
IFRS 11, Joint Arrangements	1 January 2014
IFRS 12, Disclosure of Interests in Other Entities	1 January 2014
IAS 27, Separate Financial Statements (revised 2011)	1 January 2014
IAS 28, Investments in Associates and Joint Ventures (revised 2011)	1 January 2014

There are no other IFRSs or IFRIC interpretations that are not yet effective that are expected to have a material impact on the Group.

### 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.

A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries are included in the income statement from the date of acquisition.

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

Joint ventures are accounted for under the equity method where the consolidated income statement includes the Group's share of their profits and losses, and the consolidated balance sheet includes its share of their net assets within equity accounted investments.

The assets and liabilities of overseas subsidiaries and equity accounted investments are translated at the exchange rates ruling at the balance sheet date. The income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences 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 in equity since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

# Consolidated income statement

for the year ended 31 December

		2013		Restated <sup>1</sup> 2012 <sup>2</sup>	
	Notes	£m	Total £m	£m	Total £m
<b>Continuing operations</b>					
<b>Combined sales of Group and share of equity accounted investments</b>	1		<b>18,180</b>		17,905
Less: share of sales of equity accounted investments	1		<b>(1,316)</b>		(1,214)
<b>Revenue</b>	1		<b>16,864</b>		16,691
Operating costs	2		<b>(16,297)</b>		(15,459)
Other income	4		<b>128</b>		282
<b>Group operating profit</b>			<b>695</b>		1,514
Share of results of equity accounted investments	1		<b>111</b>		91
Underlying EBITA <sup>3</sup>			<b>1,925</b>		1,862
Non-recurring items <sup>4</sup>			<b>6</b>		103
EBITA			<b>1,931</b>		1,965
Amortisation	11		<b>(189)</b>		(226)
Impairment	11		<b>(887)</b>		(86)
Financial expense of equity accounted investments	5		<b>(8)</b>		(7)
Taxation expense of equity accounted investments			<b>(41)</b>		(41)
<b>Operating profit</b>	1		<b>806</b>		1,605
Financial income			<b>216</b>		452
Financial expense			<b>(600)</b>		(855)
<b>Finance costs</b>	5		<b>(384)</b>		(403)
<b>Profit before taxation</b>			<b>422</b>		1,202
Taxation expense	6		<b>(246)</b>		(243)
<b>Profit for the year</b>			<b>176</b>		959
<b>Attributable to:</b>					
Equity shareholders			<b>168</b>		948
Non-controlling interests			<b>8</b>		11
			<b>176</b>		959
<b>Earnings per share</b>					
	8				
Basic earnings per share			<b>5.2p</b>		29.3p
Diluted earnings per share			<b>5.2p</b>		29.1p

1 On adoption of the revised IAS 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

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

4 Comprises profit on disposal of businesses of £6m (2012 £103m).

# Consolidated statement of comprehensive income

for the year ended 31 December

	Notes	2013			Restated <sup>1</sup> 2012		
		Other reserves <sup>2</sup> £m	Retained earnings £m	Total £m	Other reserves <sup>2</sup> £m	Retained earnings £m	Total £m
<b>Profit for the year</b>		<b>–</b>	<b>176</b>	<b>176</b>	<b>–</b>	<b>959</b>	<b>959</b>
<b>Other comprehensive income</b>							
<b>Items that will not be reclassified to the income statement:</b>							
Remeasurements on defined benefit pension schemes:							
Subsidiaries		–	918	918	–	(625)	(625)
Equity accounted investments		–	8	8	–	(81)	(81)
Tax on items that will not be reclassified to the income statement	6	–	(421)	(421)	–	119	119
<b>Items that may be reclassified to the income statement:</b>							
Currency translation on foreign currency net investments:							
Subsidiaries		(246)	–	(246)	(164)	–	(164)
Equity accounted investments		(3)	–	(3)	(25)	–	(25)
Reclassification of cumulative currency translation reserve on disposal	26	(8)	–	(8)	(97)	–	(97)
Amounts credited/(charged) to hedging reserve	16	53	–	53	(21)	–	(21)
Tax on items that may be reclassified to the income statement	6	(14)	–	(14)	5	–	5
<b>Total other comprehensive income for the year (net of tax)</b>		<b>(218)</b>	<b>505</b>	<b>287</b>	<b>(302)</b>	<b>(587)</b>	<b>(889)</b>
<b>Total comprehensive income for the year</b>		<b>(218)</b>	<b>681</b>	<b>463</b>	<b>(302)</b>	<b>372</b>	<b>70</b>
<b>Attributable to:</b>							
Equity shareholders		(212)	673	461	(302)	361	59
Non-controlling interests		(6)	8	2	–	11	11
		<b>(218)</b>	<b>681</b>	<b>463</b>	<b>(302)</b>	<b>372</b>	<b>70</b>

1 On adoption of the revised IAS 19, Employee Benefits.

2 An analysis of other reserves is provided in note 25.



# Notes to the Group accounts – income statement

## 1. Segmental analysis

### Revenue and profit recognition

Sales include the Group's 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.

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. Profit is recognised progressively as risks have been mitigated or retired.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

### Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

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 determined on an arm's length basis.

### Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Where the research and development activity is performed on behalf of customers, the revenue arising is recognised in the income statement in accordance with the Group's revenue recognition policy.

### Key Performance Indicator – Underlying EBITA

Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as underlying EBITA. Underlying EBITA is the measure of profit on which segmental performance is monitored by management. As such, underlying EBITA is disclosed on page 132 on a segmental basis and reconciled to the reporting segment result and operating profit in the consolidated financial statements.

### Reporting segments

The Group has six reporting segments which align with the Group's strategic direction:

- **Electronic Systems** comprises the US and UK-based electronics activities, including electronic warfare systems and electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems;
- **Cyber & Intelligence** comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence business, and covers the Group's cyber, secure government, and commercial and financial security activities;
- **Platforms & Services (US)** comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, and the US-based services and sustainment activities, including ship repair and munitions services;
- **Platforms & Services (UK)** comprises the Group's UK-based air, maritime, combat vehicle, munitions and certain shared services activities;
- **Platforms & Services (International)** comprises the Group's businesses in Saudi Arabia, Australia, India and Oman, together with its 37.5% interest in the pan-European MBDA joint venture; and
- **HQ** comprises the Group's head office activities, together with a 49% interest in Air Astana.

Management monitors the results of these reporting segments to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on combined sales of the Group and its share of equity accounted investments, and underlying EBITA. Finance costs and taxation expense are managed on a Group basis.

## 1. Segmental analysis (continued)

### Sales and revenue by reporting segment

	Combined sales of Group and share of equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	2013 £m	2012 <sup>1</sup> £m	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 <sup>1</sup> £m
Electronic Systems	2,466	2,507	(61)	(52)	61	52	2,466	2,507
Cyber & Intelligence	1,243	1,402	–	–	–	–	1,243	1,402
Platforms & Services (US)	4,196	4,539	(75)	(70)	1	1	4,122	4,470
Platforms & Services (UK)	6,890	5,717	(1,169)	(1,430)	1,077	1,346	6,798	5,633
Platforms & Services (International)	4,063	4,071	(873)	(830)	–	–	3,190	3,241
HQ	306	267	(306)	(267)	–	–	–	–
	19,164	18,503	(2,484)	(2,649)	1,139	1,399	17,819	17,253
Intra-group sales/revenue	(984)	(598)	–	2	29	34	(955)	(562)
	18,180	17,905	(2,484)	(2,647)	1,168	1,433	16,864	16,691

	Intra-group revenue		Revenue from external customers	
	2013 £m	2012 £m	2013 £m	2012 <sup>1</sup> £m
Electronic Systems	100	102	2,366	2,405
Cyber & Intelligence	21	22	1,222	1,380
Platforms & Services (US)	72	54	4,050	4,416
Platforms & Services (UK)	756	375	6,042	5,258
Platforms & Services (International)	6	9	3,184	3,232
	955	562	16,864	16,691

### Sales and revenue by customer location

	Sales		Revenue	
	2013 £m	2012 <sup>1</sup> £m	2013 £m	2012 <sup>1</sup> £m
UK	3,678	3,689	3,515	3,549
Rest of Europe <sup>2</sup>	2,361	2,500	1,565	1,751
Saudi Arabia	3,556	2,411	3,430	2,331
Rest of Middle East	241	159	130	51
US	6,686	7,349	6,685	7,345
Canada	49	57	49	57
Australia	822	1,119	819	1,117
Rest of Asia and Pacific	616	381	516	262
Africa, Central and South America	171	240	155	228
	18,180	17,905	16,864	16,691

### Revenue by category

	2013 £m	2012 <sup>1</sup> £m
Long-term contracts	9,618	8,969
Sale of goods	3,576	4,020
Provision of services	3,665	3,686
Royalty income	5	16
	16,864	16,691

### Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2013 £m	2012 <sup>1</sup> £m
UK Ministry of Defence <sup>2</sup>	4,196	4,486
US Department of Defense	4,347	4,986
Kingdom of Saudi Arabia Ministry of Defence and Aviation	3,399	2,302

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by the five principal reporting segments. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the Platforms & Services (UK) and Platforms & Services (International) reporting segments.

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation within Platforms & Services (UK) (see note 7).

2 Includes £1.0bn (2012 £1.3bn) generated under the Typhoon work share agreement with Eurofighter Jagdflugzeug GmbH.

Notes to the Group accounts – income statement *continued*

## 1. Segmental analysis (continued)

## Reporting segment result

	Underlying EBITA <sup>3</sup>		Non-recurring items <sup>4</sup>		Amortisation of intangible assets		Impairment of intangible assets		Reporting segment result	
	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
Electronic Systems	346	356	–	–	(15)	(22)	(4)	(2)	327	332
Cyber & Intelligence	115	124	–	–	(63)	(76)	(425)	–	(373)	48
Platforms & Services (US)	265	394	7	103	(21)	(92)	(458)	(84)	(207)	321
Platforms & Services (UK)	879	695	–	–	(84)	(28)	–	–	795	667
Platforms & Services (International)	429	417	(1)	–	(6)	(8)	–	–	422	409
HQ	(109)	(124)	–	–	–	–	–	–	(109)	(124)
	1,925	1,862	6	103	(189)	(226)	(887)	(86)	855	1,653
Financial expense of equity accounted investments									(8)	(7)
Taxation expense of equity accounted investments									(41)	(41)
<b>Operating profit</b>									806	1,605
Finance costs									(384)	(403)
<b>Profit before taxation</b>									422	1,202
Taxation expense									(246)	(243)
<b>Profit for the year</b>									176	959

## Share of results of equity accounted investments within reporting segments

	2013 £m	Restated <sup>1</sup> 2012 £m
Share of results excluding financial and taxation expense:		
Electronic Systems	3	(2)
Platforms & Services (US)	4	1
Platforms & Services (UK)	16	11
Platforms & Services (International)	112	108
HQ	25	21
	160	139
Financial expense	(8)	(7)
Taxation expense	(41)	(41)
	111	91

1 On adoption of the revised IAS 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation within Platforms & Services (UK) (see note 7).

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

4 Comprises profit on disposal of businesses of £6m (2012 £103m).

## 2. Operating costs

### Leases

Payments, including any incentives, made under operating leases are recognised in the income statement on a straight-line basis over the lease term.

Lease incentives granted are charged to the income statement over the term of the lease.

### Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on both research and development activities not meeting the conditions for capitalisation is written off as incurred and charged to the income statement.

Customer-funded expenditure on research and development activities is held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Group's revenue recognition policy.

	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
Raw materials, subcontracts and other bought-in items	6,205	6,187
Change in inventories of finished goods and work-in-progress	275	24
Cost of inventories expensed	6,480	6,211
Staff costs (note 3)	5,054	5,300
Depreciation, amortisation and impairment	1,397	669
Loss on disposal of property, plant and equipment, and investment property	9	5
Loss on disposal of businesses	4	–
Other operating charges	3,353	3,274
<b>Operating costs</b>	<b>16,297</b>	<b>15,459</b>

Included within the analysis of operating costs are the following expenses:

Lease and sublease expense	185	189
Research and development expense including amounts funded under contract	1,051	1,138

1 On adoption of the revised IAS 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

### Fees payable to the Company's auditor and its associates included in operating costs

	2013			2012		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
<b>Fees payable to the Company's auditor for the audit of the Company's annual accounts*</b>	<b>1,621</b>	<b>–</b>	<b>1,621</b>	1,570	–	1,570
<b>Fees payable to the Company's auditor and its associates for other services pursuant to legislation:</b>						
The audit of the Company's subsidiaries*	2,628	3,994	6,622	2,524	3,836	6,360
Interim review*	486	–	486	623	–	623
Other	41	2	43	103	29	132
<b>Audit-related assurance services:</b>						
Advice on accounting matters	9	1	10	8	20	28
<b>Tax compliance services</b>	<b>76</b>	<b>512</b>	<b>588</b>	320	662	982
<b>Tax advisory services</b>	<b>63</b>	<b>185</b>	<b>248</b>	126	166	292
<b>Corporate finance services:</b>						
M&A	108	–	108	236	35	271
<b>Other assurance services:</b>						
Due diligence	–	40	40	–	235	235
IT advisory	77	–	77	56	–	56
Financial model reviews	169	–	169	–	–	–
<b>Other non-audit services</b>	<b>88</b>	<b>93</b>	<b>181</b>	125	73	198
<b>Total fees payable to the Company's auditor and its associates</b>	<b>5,366</b>	<b>4,827</b>	<b>10,193</b>	5,691	5,056	10,747
*Total fees payable to the Company's auditor and its associates for audit services and interim review			8,729			8,553
<b>Fees in respect of BAE Systems pension schemes:</b>						
Audit	146	256	402	147	268	415
Tax compliance	47	6	53	85	26	111
Tax advisory	31	–	31	64	–	64
	<b>224</b>	<b>262</b>	<b>486</b>	296	294	590



# Notes to the Group accounts – income statement *continued*

## 3. Employees

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	<b>2013</b> Number '000	2012 Number '000	<b>2013</b> Number '000	2012 Number '000
Electronic Systems	<b>12</b>	13	<b>12</b>	13
Cyber & Intelligence	<b>8</b>	8	<b>8</b>	8
Platforms & Services (US)	<b>20</b>	23	<b>19</b>	21
Platforms & Services (UK)	<b>28</b>	28	<b>28</b>	27
Platforms & Services (International)	<b>11</b>	11	<b>10</b>	11
HQ	<b>1</b>	1	<b>1</b>	1
	<b>80</b>	84	<b>78</b>	81

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	<b>2013</b> £m	2012 <sup>1</sup> £m
Wages and salaries	<b>4,367</b>	4,560
Social security costs	<b>352</b>	368
Share-based payments (note 29)	<b>21</b>	26
Pension costs – defined contribution plans (note 23)	<b>130</b>	129
Pension costs – defined benefit plans (note 23)	<b>183</b>	212
US healthcare costs (note 23)	<b>1</b>	5
	<b>5,054</b>	5,300

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

## 4. Other income

### Lease income

Rental income is recognised in other income on a straight-line basis over the term of the relevant lease.

	<b>2013</b> £m	2012 <sup>1</sup> £m
Rental income from operating leases – investment property	<b>21</b>	21
Rental income from operating leases – other	<b>20</b>	19
Profit on disposal of investment property	<b>16</b>	14
Profit on disposal of property, plant and equipment	<b>12</b>	10
Profit on disposal of businesses	<b>10</b>	103
Management recharges to equity accounted investments (note 30)	<b>17</b>	18
Pension curtailment gains (note 23)	–	26
US healthcare curtailment gains (note 23)	–	16
Other <sup>2</sup>	<b>32</b>	55
<b>Other income</b>	<b>128</b>	282

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

2 There are no individual amounts in excess of £10m.

## 5. Finance costs

### Borrowing costs

Borrowing costs are recognised in the income statement in the period in which they are incurred.

	2013 £m	Restated <sup>1</sup> 2012 £m
Interest income	48	39
Gain on remeasurement of financial instruments at fair value through profit or loss	51	280
Foreign exchange gains	117	133
Financial income	216	452
Interest expense on bonds and other financial instruments	(197)	(187)
Facility fees	(11)	(7)
Net present value adjustments	(20)	(56)
Net interest expense on retirement benefit obligations (note 23)	(186)	(187)
Loss on remeasurement of financial instruments at fair value through profit or loss	(146)	(250)
Foreign exchange losses	(40)	(168)
Financial expense	(600)	(855)
<b>Finance costs</b>	<b>(384)</b>	<b>(403)</b>

### Additional analysis

	2013 £m	Restated <sup>1</sup> 2012 £m
Finance costs:		
Group	(384)	(403)
Share of equity accounted investments	(8)	(7)
	<b>(392)</b>	<b>(410)</b>
Analysed as:		
Underlying interest (expense)/income:		
Group	(180)	(211)
Share of equity accounted investments	1	7
	<b>(179)</b>	<b>(204)</b>
Other:		
Group:		
Net interest expense on retirement benefit obligations	(186)	(187)
Fair value and foreign exchange adjustments on financial instruments and investments	(18)	(5)
Share of equity accounted investments	(9)	(14)
	<b>(392)</b>	<b>(410)</b>

1 On adoption of the revised IAS 19, Employee Benefits.

# Notes to the Group accounts – income statement *continued*

## 6. Taxation expense

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

### Current tax

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

### Deferred tax

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

- on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;
- related to investments in subsidiaries and equity accounted investments to the extent that it is probable that they will not reverse in the foreseeable future; and
- arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

### Taxation expense

	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
<b>Current taxation</b>		
UK:		
Current tax	(179)	(98)
Double tax relief	1	1
Adjustment in respect of prior years	(16)	5
	(194)	(92)
Overseas:		
Current year	(106)	(170)
Adjustment in respect of prior years	22	12
	(84)	(158)
	(278)	(250)
<b>Deferred taxation</b>		
UK:		
Origination and reversal of temporary differences	22	20
Adjustment in respect of prior years	25	2
Tax rate adjustment <sup>3</sup>	(8)	(10)
	39	12
Overseas:		
Origination and reversal of temporary differences	6	8
Adjustment in respect of prior years	(13)	(13)
	(7)	(5)
	32	7
<b>Taxation expense</b>	(246)	(243)
UK	(155)	(80)
Overseas	(91)	(163)
<b>Taxation expense</b>	(246)	(243)

1 On adoption of the revised IAS 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

3 The UK current tax rate will be reduced from 23% to 21% with effect from 1 April 2014, and then to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

## 6. Taxation expense (continued)

### 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.

	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
<b>Profit before taxation</b>	<b>422</b>	1,202
UK corporation tax rate	23.25%	24.5%
Expected income tax expense	(98)	(294)
Effect of tax rates in foreign jurisdictions, including US state taxes	(24)	(43)
Expenses not tax effected	(9)	(15)
Income not subject to tax	17	12
Research and development tax credits and patent box benefits	39	24
Non-deductible goodwill impairment	(201)	(14)
Chargeable gains and non-taxable gains/non-deductible losses on disposal of businesses	(1)	17
Utilisation of previously unrecognised tax losses	5	9
Current year losses not tax effected	–	(2)
Recoverable deferred tax asset previously unrecognised	5	20
Adjustments in respect of prior years	18	6
Adjustments in respect of equity accounted investments	26	22
Tax rate adjustment <sup>3</sup>	(8)	(10)
Other	(15)	25
<b>Taxation expense</b>	<b>(246)</b>	(243)

### Calculation of the effective tax rate

	2013 £m	Restated <sup>1</sup> 2012 <sup>2</sup> £m
Profit before taxation	422	1,202
Add back/(deduct):		
Taxation expense of equity accounted investments (note 1)	41	41
Profit on disposal of businesses (notes 2 and 4)	(6)	(103)
Goodwill impairment (note 11)	865	57
	<b>1,322</b>	1,197

### Taxation expense (including equity accounted investments)

	(287)	(284)
Represented by:		
Group	(246)	(243)
Equity accounted investments	(41)	(41)

### Effective tax rate

	22%	24%
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1 On adoption of the revised IAS 19, Employee Benefits.

2 Re-presented on classification of the Regional Aircraft line of business as a continuing operation (see note 7).

3 The UK current tax rate will be reduced from 23% to 21% with effect from 1 April 2014, and then to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.



Notes to the Group accounts – income statement *continued*

## 6. Taxation expense (continued)

## Tax recognised in other comprehensive income

	2013			Restated <sup>1</sup> 2012		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
<b>Items that will not be reclassified to the income statement:</b>						
Remeasurements on defined benefit pension schemes:						
Subsidiaries	918	(323)	595	(625)	175	(450)
Equity accounted investments	8	(7)	1	(81)	10	(71)
Share-based payments	–	4	4	–	2	2
Other	–	1	1	–	2	2
Tax rate adjustment <sup>2</sup>	–	(96)	(96)	–	(70)	(70)
<b>Items that may be reclassified to the income statement:</b>						
Currency translation on foreign currency net investments:						
Subsidiaries	(246)	–	(246)	(164)	–	(164)
Equity accounted investments	(3)	–	(3)	(25)	–	(25)
Reclassification of cumulative currency translation reserve on disposal	(8)	–	(8)	(97)	–	(97)
Amounts credited/(charged) to hedging reserve	53	(14)	39	(21)	5	(16)
	722	(435)	287	(1,013)	124	(889)

	2013			Restated <sup>1</sup> 2012		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
<b>Current tax</b>						
Financial instruments	1	–	1	–	–	–
Pensions	–	60	60	–	122	122
Other	–	2	2	–	3	3
	1	62	63	–	125	125
<b>Deferred tax</b>						
Subsidiaries	(15)	(380)	(395)	5	54	59
Tax rate adjustment <sup>2</sup>	–	(96)	(96)	–	(70)	(70)
Equity accounted investments – pensions	–	(7)	(7)	–	10	10
	(15)	(483)	(498)	5	(6)	(1)
<b>Tax on other comprehensive income</b>	(14)	(421)	(435)	5	119	124

1. On adoption of the revised IAS 19, Employee Benefits.

2. The UK current tax rate will be reduced from 23% to 21% with effect from 1 April 2014, and then to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

## 7. Assets held for sale and discontinued operations

### Held for sale

Non-current assets and disposal groups held for sale comprise assets and liabilities that are expected to be recovered primarily through sale rather than continuing use.

The non-current assets and disposal groups are measured at the lower of their carrying value and fair value less costs to sell.

### Discontinued operations

A discontinued operation is a component of the Group's business that represents a separate major line of business that has been disposed of or meets the criteria as held for sale. When an operation is classified as a discontinued operation, the comparative income statement is re-presented as if the operation had been discontinued from the start of the comparative period.

### Assets held for sale

A residential and office facility in Saudi Arabia is classified as held for sale at 31 December 2013 (net book value £140m). A sale and leaseback transaction for the facility was completed on 9 January 2014, with proceeds of £162m.

### Regional Aircraft

The assets and liabilities of the Regional Aircraft Support & Engineering business were classified as held for sale at 31 December 2012 and, accordingly, its results were presented within discontinued operations in the Annual Report 2012.

In 2013, marketing of the business for sale ceased and, accordingly, its assets and liabilities are not classified as held for sale at 31 December 2013. The results of the business are presented in continuing operations within the Platforms & Services (UK) reporting segment in the Annual Report 2013.

Notes to the Group accounts – income statement *continued*

## 8. Earnings per share

**Key Performance Indicator – Underlying earnings per share**

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.

	2013			Restated <sup>1</sup> 2012		
	£m	Basic pence per share	Diluted pence per share	£m	Basic pence per share	Diluted pence per share
Profit for the year attributable to equity shareholders	168	5.2	5.2	948	29.3	29.1
(Deduct)/add back:						
Profit on disposal of businesses	(6)			(103)		
Net interest expense on retirement benefit obligations, post tax	153			153		
Fair value and foreign exchange adjustments on financial instruments and investments, post tax	14			4		
Amortisation and impairment of intangible assets, post tax	165			194		
Impairment of goodwill	865			57		
<b>Underlying earnings, post tax</b>	<b>1,359</b>	<b>42.0</b>	<b>41.8</b>	<b>1,253</b>	<b>38.7</b>	<b>38.5</b>
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		3,234	3,234		3,244	3,244
Incremental shares in respect of employee share schemes			14			14
Weighted average number of shares used in calculating diluted earnings per share			3,248			3,258

1. On adoption of the revised IAS 19, Employee Benefits.

# Consolidated cash flow statement

for the year ended 31 December

	Notes	2013 £m	Restated <sup>1</sup> 2012 £m
<b>Profit for the year</b>		<b>176</b>	959
Taxation expense	6	<b>246</b>	243
Share of results of equity accounted investments	1	<b>(111)</b>	(91)
Finance costs	5	<b>384</b>	403
Depreciation, amortisation and impairment	2	<b>1,397</b>	669
Profit on disposal of property, plant and equipment	2,4	<b>(6)</b>	(7)
Profit on disposal of investment property	2,4	<b>(13)</b>	(12)
Profit on disposal of businesses	2,4	<b>(6)</b>	(103)
Cost of equity-settled employee share schemes		<b>49</b>	57
Movements in provisions		<b>63</b>	(224)
Decrease in liabilities for retirement benefit obligations		<b>(337)</b>	(820)
(Increase)/decrease in working capital:			
Inventories		<b>(35)</b>	6
Trade and other receivables		<b>(275)</b>	447
Trade and other payables		<b>(1,327)</b>	931
<b>Cash inflow from operating activities</b>		<b>205</b>	2,458
Interest paid		<b>(177)</b>	(170)
Taxation paid		<b>(138)</b>	(115)
<b>Net cash (outflow)/inflow from operating activities</b>		<b>(110)</b>	2,173
Dividends received from equity accounted investments	14	<b>95</b>	94
Interest received		<b>11</b>	23
Purchase of property, plant and equipment, and investment property		<b>(236)</b>	(359)
Purchase of intangible assets		<b>(33)</b>	(43)
Proceeds from sale of property, plant and equipment, and investment property		<b>93</b>	115
Proceeds from sale of intangible assets		<b>28</b>	–
Purchase of subsidiary undertakings (net of cash acquired)	9	<b>(1)</b>	(5)
Equity accounted investment funding	14	<b>(5)</b>	(6)
Proceeds from sale of subsidiary undertakings (net of cash disposed)	9	<b>5</b>	101
<b>Net cash outflow from investing activities</b>		<b>(43)</b>	(80)
Net purchase of own shares		<b>(212)</b>	(16)
Equity dividends paid	25	<b>(638)</b>	(620)
Dividends paid to non-controlling interests		<b>(11)</b>	(11)
Cash outflow from matured derivative financial instruments		<b>(47)</b>	(119)
Cash outflow from movement in cash collateral		<b>(10)</b>	(2)
Cash inflow from loans		<b>–</b>	1,863
Cash outflow from repayment of loans		<b>–</b>	(1,975)
<b>Net cash outflow from financing activities</b>		<b>(918)</b>	(880)
<b>Net (decrease)/increase in cash and cash equivalents</b>		<b>(1,071)</b>	1,213
Cash and cash equivalents at 1 January		<b>3,334</b>	2,136
Effect of foreign exchange rate changes on cash and cash equivalents		<b>(41)</b>	(15)
<b>Cash and cash equivalents at 31 December</b>		<b>2,222</b>	3,334
Comprising:			
Cash and cash equivalents	19	<b>2,222</b>	3,355
Overdrafts	21	<b>–</b>	(21)
<b>Cash and cash equivalents at 31 December</b>		<b>2,222</b>	3,334

1 On adoption of the revised IAS 19, Employee Benefits.

# Notes to the Group accounts – cash flow statement

## 9. Cash flow analysis

### Operating business cash flow

	2013 £m	2012 £m
Cash inflow from operating activities	205	2,458
Add back: Amounts already deducted from net (debt)/cash (as defined by the Group) <sup>2</sup>	–	458
	205	2,916
Assets contributed to Trust	–	(25)
Purchase of property, plant and equipment, and investment property	(236)	(359)
Purchase of intangible assets	(33)	(43)
Proceeds from sale of property, plant and equipment, and investment property	93	115
Proceeds from sale of intangible assets	28	–
Equity accounted investment funding	(5)	(6)
Dividends received from equity accounted investments	95	94
<b>Operating business cash flow</b>	<b>147</b>	<b>2,692</b>

	2013 £m	2012 <sup>1</sup> £m
Electronic Systems	235	256
Cyber & Intelligence	118	113
Platforms & Services (US)	192	314
Platforms & Services (UK)	59	1,717
Platforms & Services (International)	(189)	506
HQ	(268)	(214)
<b>Operating business cash flow</b>	<b>147</b>	<b>2,692</b>

1 Re-presented on classification of the Regional Aircraft line of business as a continuing operation within Platforms & Services (UK) (see note 7).

2 2012 comprised the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net (debt)/cash.

### Cash flows from acquisitions and disposals

	2013 £m	2012 £m
Proceeds from sale of subsidiary undertakings <sup>3</sup>	7	112
Cash and cash equivalents disposed of with subsidiary undertakings	(2)	(11)
<b>Proceeds from sale of subsidiary undertakings (net of cash disposed)</b>	<b>5</b>	<b>101</b>
Purchase of subsidiary undertakings (net of cash acquired)	(1)	(5)
<b>Acquisitions and disposals</b>	<b>4</b>	<b>96</b>

3 In 2012, the Group received £108m in respect of the subsidiaries sold during the year (see note 26) and £4m in respect of sales price adjustments relating to the sale of the Regional Aircraft Asset Management business in 2011.



## 10. Net (debt)/cash (as defined by the Group)

### Key Performance Indicator – Net (debt)/cash

Net (debt)/cash comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account<sup>1</sup>.

#### Movement in net (debt)/cash (as defined by the Group)

	2013 £m	2012 £m
Operating business cash flow (note 9)	147	2,692
Interest	(166)	(147)
Taxation	(138)	(115)
Free cash (outflow)/inflow	(157)	2,430
Acquisitions and disposals (note 9)	4	96
Equity dividends paid	(638)	(620)
Dividends paid to non-controlling interests	(11)	(11)
Net purchase of own shares	(212)	(16)
Cash outflow from matured derivative financial instruments	(47)	(119)
Cash outflow from movement in cash collateral	(10)	(2)
Movement in cash received on customers' account <sup>1</sup>	1	1
Foreign exchange adjustments	3	92
Other non-cash movements	(19)	(25)
Movement in net (debt)/cash (as defined by the Group)	(1,086)	1,826
Opening net cash/(debt) (as defined by the Group)	387	(1,439)
<b>Closing net (debt)/cash (as defined by the Group)</b>	<b>(699)</b>	<b>387</b>

#### Components of net (debt)/cash (as defined by the Group)

	2013 £m	2012 £m
Debt-related derivative financial instrument assets – non-current (note 16)	–	22
Debt-related derivative financial instrument assets – current (note 16)	6	–
Cash and cash equivalents (note 19)	2,222	3,355
	<b>2,228</b>	<b>3,377</b>
Loans – non-current (note 21)	(2,524)	(2,967)
Loans and overdrafts – current (note 21)	(402)	(21)
Less: Cash received on customers' account <sup>1</sup> (note 22)	(1)	(2)
	<b>(2,927)</b>	<b>(2,990)</b>
<b>Net (debt)/cash (as defined by the Group)</b>	<b>(699)</b>	<b>387</b>

<sup>1</sup> 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 consolidated balance sheet (see note 22).

# Consolidated balance sheet

as at 31 December

	Notes	2013 £m	2012 £m
<b>Non-current assets</b>			
Intangible assets	11	9,735	10,928
Property, plant and equipment	12	1,936	2,285
Investment property	13	135	122
Equity accounted investments	14	283	265
Other investments		3	5
Other receivables	15	477	254
Other financial assets	16	42	62
Deferred tax assets	17	901	1,375
		<b>13,512</b>	15,296
<b>Current assets</b>			
Inventories	18	680	655
Trade and other receivables including amounts due from customers for contract work	15	3,038	2,873
Current tax		8	11
Other financial assets	16	81	64
Cash and cash equivalents	19	2,222	3,355
Assets held for sale	7	140	20
		<b>6,169</b>	6,978
<b>Total assets</b>	20	<b>19,681</b>	22,274
<b>Non-current liabilities</b>			
Loans	21	(2,524)	(2,967)
Trade and other payables	22	(1,160)	(1,481)
Retirement benefit obligations	23	(3,665)	(4,607)
Other financial liabilities	16	(59)	(66)
Deferred tax liabilities	17	(7)	(13)
Provisions	24	(403)	(449)
		<b>(7,818)</b>	(9,583)
<b>Current liabilities</b>			
Loans and overdrafts	21	(402)	(21)
Trade and other payables	22	(7,074)	(8,067)
Other financial liabilities	16	(81)	(88)
Current tax		(497)	(422)
Provisions	24	(391)	(297)
Liabilities held for sale		–	(22)
		<b>(8,445)</b>	(8,917)
<b>Total liabilities</b>		<b>(16,263)</b>	(18,500)
<b>Net assets</b>		<b>3,418</b>	3,774
<b>Capital and reserves</b>			
Issued share capital	25	89	90
Share premium		1,249	1,249
Other reserves	25	4,868	5,079
Retained earnings – deficit		(2,825)	(2,698)
<b>Total equity attributable to equity holders of the parent</b>		<b>3,381</b>	3,720
<b>Non-controlling interests</b>		<b>37</b>	54
<b>Total equity</b>		<b>3,418</b>	3,774

Approved by the Board on 19 February 2014 and signed on its behalf by:

I G King  
Chief Executive

P J Lynas  
Group Finance Director

# Consolidated statement of changes in equity

for the year ended 31 December

	Attributable to equity holders of the parent					Non-controlling interests £m	Total equity £m
	Issued share capital £m	Share premium £m	Other reserves <sup>1</sup> £m	Retained earnings £m	Total £m		
At 1 January 2013	90	1,249	5,079	(2,698)	3,720	54	3,774
Profit for the year	–	–	–	168	168	8	176
Total other comprehensive income for the year	–	–	(212)	505	293	(6)	287
Share-based payments	–	–	–	49	49	–	49
Net purchase of own shares	(1)	–	1	(212)	(212)	–	(212)
Ordinary share dividends	–	–	–	(638)	(638)	(11)	(649)
Disposal of non-controlling interest	–	–	–	1	1	(8)	(7)
<b>At 31 December 2013</b>	<b>89</b>	<b>1,249</b>	<b>4,868</b>	<b>(2,825)</b>	<b>3,381</b>	<b>37</b>	<b>3,418</b>
At 1 January 2012	90	1,249	5,381	(2,480)	4,240	59	4,299
Profit for the year <sup>2</sup>	–	–	–	948	948	11	959
Total other comprehensive income for the year <sup>2</sup>	–	–	(302)	(587)	(889)	–	(889)
Share-based payments	–	–	–	57	57	–	57
Net purchase of own shares	–	–	–	(16)	(16)	–	(16)
Ordinary share dividends	–	–	–	(620)	(620)	(11)	(631)
Other	–	–	–	–	–	(5)	(5)
At 31 December 2012	90	1,249	5,079	(2,698)	3,720	54	3,774

1 An analysis of other reserves is provided in note 25.

2 Restated on adoption of the revised IAS 19, Employee Benefits.

# Notes to the Group accounts – balance sheet

## 11. Intangible assets

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

### Cost or valuation

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The Group's accounting policy on business combinations is included in note 26.

### 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. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

### Programme and customer-related

The most significant intangible assets recognised by the Group are in relation to ongoing programmes within businesses acquired, mainly in respect of customer relationships and order backlog.

### Other intangible assets

Other intangible assets include:

- **Computer software licences acquired** 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;
- **Software development 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. Group-funded expenditure associated with enhancing or maintaining computer software programs for sale is recognised as an expense as incurred;
- **Research and development expenditure** funded by the Group on development activities applied to a plan or design for the production of new or substantially improved products 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; and
- **Patents, trademarks and licences.**

### Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of the intangible assets.

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.

The estimated useful lives are as follows:

<b>Programme and customer-related</b>	up to 15 years
<b>Other intangible assets:</b>	
Computer software licences acquired	2 to 5 years
Software development costs	2 to 5 years
Research and development expenditure	up to 10 years
Patents, trademarks and licences	up to 20 years
Other intangibles	up to 10 years

The Group has no indefinite life intangible assets other than goodwill.

### Impairment of intangible assets, property, plant and equipment, investment property and equity accounted investments

The carrying amounts of the Group's intangible assets, property, plant and equipment, investment property 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.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

The recoverable amount is the greater of fair value less costs 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 flows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Impairment losses are recognised in the income statement.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other intangible assets, property, plant and equipment, investment property and equity accounted investments is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised or 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.

## 11. Intangible assets (continued)

	Goodwill £m	Programme and customer- related £m	Other £m	Total £m
<b>Cost or valuation</b>				
At 1 January 2012	13,900	2,124	577	16,601
Additions:				
Acquired separately	–	–	39	39
Internally developed	–	–	8	8
Adjustment on finalisation of provisional goodwill	2	–	–	2
Transfer from property, plant and equipment	–	–	40	40
Transfer to held for sale <sup>1</sup>	(227)	(165)	(94)	(486)
Disposals	(12)	(37)	(4)	(53)
Foreign exchange adjustments	(305)	(63)	(15)	(383)
At 31 December 2012	13,358	1,859	551	15,768
Additions:				
Acquired separately	–	–	24	24
Internally developed	–	–	12	12
Disposals	–	(95)	(62)	(157)
Business disposals	(25)	(6)	(16)	(47)
Foreign exchange adjustments	(153)	(29)	(5)	(187)
<b>At 31 December 2013</b>	<b>13,180</b>	<b>1,729</b>	<b>504</b>	<b>15,413</b>
<b>Amortisation and impairment</b>				
At 1 January 2012	3,224	1,545	367	5,136
Amortisation charge	–	160	66	226
Impairment charge	57	11	18	86
Transfer from property, plant and equipment	–	–	6	6
Transfer to held for sale <sup>1</sup>	(227)	(155)	(81)	(463)
Disposals	(12)	(25)	(4)	(41)
Foreign exchange adjustments	(50)	(51)	(9)	(110)
At 31 December 2012	2,992	1,485	363	4,840
Amortisation charge	–	141	48	189
Impairment charge	865	5	17	887
Disposals	–	(95)	(34)	(129)
Business disposals	(20)	(6)	(12)	(38)
Foreign exchange adjustments	(38)	(28)	(5)	(71)
<b>At 31 December 2013</b>	<b>3,799</b>	<b>1,502</b>	<b>377</b>	<b>5,678</b>
<b>Net book value</b>				
<b>At 31 December 2013</b>	<b>9,381</b>	<b>227</b>	<b>127</b>	<b>9,735</b>
At 31 December 2012	10,366	374	188	10,928
At 1 January 2012	10,676	579	210	11,465

1 Represents the intangible assets of the Safariland business subsequently sold during 2012 (net book value £23m).

**Impairment testing**

In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances have been considered with regard to value-in-use calculations.

The value-in-use 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 growth rate assumptions applied. The IBP process includes the use of historic experience, available government spending data and the Group's order backlog. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.96% (2012 6.72%) (adjusted for risks specific to the market in which the cash-generating unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.



# Notes to the Group accounts – balance sheet *continued*

## 11. Intangible assets (continued)

### Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £7.5bn (2012 £8.5bn) of the Group's total goodwill balance.

Cash-generating unit	Key assumptions	Allocated goodwill		Pre-tax discount rate	
		2013 £bn	2012 £bn	2013 %	2012 %
Electronic Systems	Continued demand from the US government for electronic warfare systems (where the business has a leadership position), other technology-based solutions and growth in the commercial avionics market	3.1	3.1	10.8	8.2
Intelligence & Security (within Cyber & Intelligence)	Continued demand in the US for the Group's services in the areas of homeland security, law enforcement and counter-intelligence	0.9	1.3	10.8	8.2
Support Solutions (within Platforms & Services (US))	Continued demand in the US for complex infrastructure, maritime and aviation services, and operations support	0.9	1.0	10.8	8.2
Land & Armaments (within Platforms & Services (US))	Continued demand in the Group's principal markets for existing and successor military tracked vehicles, naval guns, missile launchers, artillery systems, munitions, upgrade programmes and support	2.6	3.1	9.6	7.7

The final year growth rate assumption in the value-in-use calculations, after adjusting for assumed 2% inflation, is 0% (2012 0%).

The Group monitors changes in defence budgets on an ongoing basis. In 2012, there was uncertainty as to the potential impact of Sequestration or other budget reductions that could result in indiscriminate cuts to US government spending. The future cash flow projections used did not include the potential full impact of Sequestration. In 2013, the future cash flow projections used in the IBP assume that, beyond the US 2015 fiscal year, there are defence budget reductions equivalent to Sequestration levels.

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2013 and the value-in-use calculations, for the CGUs listed above, is shown below. The table also shows the headroom assuming a 1% reduction in the terminal value growth rate assumption used in the value-in-use calculations.

Cash-generating unit	Headroom as at 31 December		Headroom assuming a 1% reduction in terminal value growth rate assumption	
	2013 £bn	2012 £bn	2013 £bn	2012 £bn
Electronic Systems	0.3	3.7	(0.2)	2.2
Intelligence & Security	–	0.5	(0.1)	0.1
Support Solutions	0.2	1.5	–	0.9
Land & Armaments	–	1.8	(0.3)	0.7

### Other CGUs

The remaining goodwill balance of £1.9bn (2012 £1.9bn) is allocated across multiple CGUs, including £0.5bn in the Applied Intelligence (formerly BAE Systems Detica) CGU, with no individual CGU exceeding 10% of the Group's total goodwill balance. The majority of the projected cash flows within these CGUs are underpinned by expected levels of primarily UK government spending on defence, aerospace and security, and the Group's ability to capture a broadly consistent market share. In the case of Applied Intelligence, the future cash flow projections are based on the expectation of growth in cyber and intelligence, in the UK and overseas government markets, together with increasing demand for products and services in commercial markets.

### Impairment – goodwill

In 2013, the impairment charge of £865m comprises the US Intelligence & Security (£417m) and Land & Armaments (£448m) CGUs. The impairments in respect of both of these businesses have arisen as a result of the increase in the Group's post-tax weighted average cost of capital and a reduction in the future cash flow projections which include an estimate of reductions in US defence spending.

In 2012, the impairment charge of £57m comprised the Safariland (£27m) and Tensylon (£12m) businesses disposed of during 2012 and the Commercial Armored Vehicles business (£18m) disposed of during 2013, all within the Land & Armaments CGU.

### Impairment – intangible assets

In 2013, the impairment charge of £22m relates to the Electronic Systems (£4m), Cyber & Intelligence (£8m) and Platforms & Services (US) (£10m) reporting segments.

In 2012, the impairment charge of £29m primarily related to the Land & Armaments business within the Platforms & Services (US) reporting segment and included £21m in respect of the Safariland business disposed of during 2012.

## 12. Property, plant and equipment

### Cost

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. The cost of demonstration assets is written off as incurred.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and impairment losses.

### Depreciation

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:

<b>Buildings</b>	up to 50 years, or the lease term if shorter
<b>Plant and machinery:</b>	
Computing equipment and motor vehicles	4 to 5 years
Other equipment	10 to 20 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.

### Impairment

The carrying amounts of the Group's property, plant and equipment are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown on page 146.

Notes to the Group accounts – balance sheet *continued*

## 12. Property, plant and equipment (continued)

	Land and buildings £m	Plant and machinery £m	Total £m
<b>Cost</b>			
At 1 January 2012	2,493	2,691	5,184
Additions	81	256	337
Transfer to other intangible assets	–	(40)	(40)
Transfer to held for sale <sup>1</sup>	(15)	(11)	(26)
Reclassification between categories	(17)	17	–
Disposals	(88)	(122)	(210)
Business disposals	(3)	(14)	(17)
Foreign exchange adjustments	(66)	(53)	(119)
At 31 December 2012	2,385	2,724	5,109
Additions	66	147	213
Acquisition of subsidiaries	1	–	1
Transfer to investment property	(22)	–	(22)
Transfer to held for sale <sup>2</sup>	(215)	–	(215)
Transfer from held for sale <sup>3</sup>	4	86	90
Reclassification between categories	18	(18)	–
Disposals	(68)	(157)	(225)
Business disposals	(9)	(5)	(14)
Foreign exchange adjustments	(57)	(42)	(99)
<b>At 31 December 2013</b>	<b>2,103</b>	<b>2,735</b>	<b>4,838</b>
<b>Depreciation and impairment</b>			
At 1 January 2012	838	1,850	2,688
Depreciation charge for the year	128	191	319
Impairment charge for the year	28	7	35
Transfer to other intangible assets	–	(6)	(6)
Transfer to held for sale <sup>1</sup>	(3)	(8)	(11)
Reclassification between categories	(5)	5	–
Disposals	(13)	(118)	(131)
Business disposals	(1)	(12)	(13)
Foreign exchange adjustments	(21)	(36)	(57)
At 31 December 2012	951	1,873	2,824
Depreciation charge for the year	131	173	304
Impairment charge for the year	9	4	13
Transfer to investment property	(11)	–	(11)
Transfer to held for sale <sup>2</sup>	(75)	–	(75)
Transfer from held for sale <sup>3</sup>	4	86	90
Disposals	(33)	(149)	(182)
Business disposals	(6)	(4)	(10)
Foreign exchange adjustments	(24)	(27)	(51)
<b>At 31 December 2013</b>	<b>946</b>	<b>1,956</b>	<b>2,902</b>
<b>Net book value</b>			
<b>At 31 December 2013</b>	<b>1,157</b>	<b>779</b>	<b>1,936</b>
At 31 December 2012	1,434	851	2,285
At 1 January 2012	1,655	841	2,496

1 Represents the property, plant and equipment of the Safariland business subsequently sold during 2012 (net book value £15m).

2 Represents a residential and office facility in Saudi Arabia (net book value £140m). A sale and leaseback transaction was completed in January 2014 (see note 7).

3 Represents the property, plant and equipment of the Regional Aircraft Support & Engineering business, which was reclassified from held for sale in 2013 (net book value £nil) (see note 7).

## 12. Property, plant and equipment (continued)

### Net book value

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	963	–	963
Long leasehold property	81	–	81
Short leasehold property	113	–	113
Plant and machinery	–	689	689
Fixtures, fittings and equipment	–	90	90
<b>At 31 December 2013</b>	<b>1,157</b>	<b>779</b>	<b>1,936</b>

### Impairment

	<b>2013 £m</b>	2012 £m
Electronic Systems	<b>2</b>	–
Platforms & Services (US)	<b>9</b>	15
Platforms & Services (UK)	<b>2</b>	–
Platforms & Services (International)	<b>–</b>	20
	<b>13</b>	35

### 2013

The Platforms & Services (US) impairment of £9m mainly reflects a charge in respect of the carrying value of land and buildings at the Sealy, Texas, facility due to its planned closure by the end of June 2014.

### 2012

The impairment charge of £35m mainly comprised charges in respect of the carrying value of land and buildings in Saudi Arabia (£20m) and assets of US businesses prior to their disposal (£7m).

### Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Total £m
<b>At 31 December 2013</b>	<b>33</b>	<b>94</b>	<b>127</b>
At 31 December 2012	23	115	138

### Operating leases

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	<b>2013 £m</b>	2012 £m
Receipts due:		
Not later than one year	<b>23</b>	24
Later than one year and not later than five years	<b>87</b>	96
Later than five years	<b>118</b>	139
	<b>228</b>	259

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.

# Notes to the Group accounts – balance sheet *continued*

## 13. Investment property

### Cost

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 impairment losses.

### Depreciation

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.

### Impairment

The carrying amounts of the Group's investment property are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown on page 146.

	£m
<b>Cost</b>	
At 1 January 2012	176
Additions	20
Disposals	(25)
At 31 December 2012	171
Additions	24
Transfer from property, plant and equipment	22
Disposals	(18)
<b>At 31 December 2013</b>	<b>199</b>
<b>Depreciation and impairment</b>	
At 1 January 2012	46
Depreciation charge for the year	3
At 31 December 2012	49
Depreciation charge for the year	4
Transfer from property, plant and equipment	11
<b>At 31 December 2013</b>	<b>64</b>
<b>Net book value</b>	
<b>At 31 December 2013</b>	<b>135</b>
At 31 December 2012	122
At 1 January 2012	130
<b>Fair value</b>	
<b>At 31 December 2013</b>	<b>263</b>
At 31 December 2012	197

The fair values above are based on and reflect current market values as prepared by in-house professionals who have the appropriate professional qualifications and recent experience of valuing properties in the location and of the type being valued.



## 14. Equity accounted investments

An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies.

### Carrying value

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 carrying amounts of the Group's equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown on page 146.

### 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 European 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
Air Astana (Held by BAE Systems (Kazakhstan) Limited)	Carriage by air of passengers and cargo	49% common	Kazakhstan	Kazakhstan

The Company has taken advantage of the exemption under Section 410(2) of the Companies Act 2006 by providing information only in relation to equity accounted investments whose results or financial position, in the opinion of the directors, principally affected the financial statements. Accordingly, the equity accounted investments listed in the table above are those that represent more than 5% of total Group sales or underlying EBITA<sup>1</sup> or that represent a significant proportion of the total carrying value of equity accounted investments. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2013 will be annexed to the Company's next annual return filed with the Registrar of Companies.

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

### Carrying value (including goodwill)

	£m
At 1 January 2012	783
Share of results after tax <sup>2</sup>	91
Equity accounted investment funding	6
Dividends received	(94)
Non-cash special dividend from MBDA SAS	(424)
Actuarial losses on defined benefit pension schemes, net of tax <sup>2</sup>	(71)
Adjustment on finalisation of provisional fair values on acquisitions	(1)
Foreign exchange adjustments	(25)
At 31 December 2012	265
Share of results after tax	111
Equity accounted investment funding	5
Dividends received	(95)
Actuarial gains on defined benefit pension schemes, net of tax	1
Disposals	(1)
Foreign exchange adjustments	(3)
<b>At 31 December 2013</b>	<b>283</b>

2. Restated on adoption of the revised IAS 19, Employee Benefits.

### Share of assets and liabilities

	2013 £m	2012 £m
<b>Assets</b>		
Non-current assets	821	781
Current assets	2,444	2,278
	<b>3,265</b>	3,059
<b>Liabilities</b>		
Non-current liabilities	(486)	(443)
Current liabilities	(2,496)	(2,351)
	<b>(2,982)</b>	(2,794)
<b>Carrying value</b>	<b>283</b>	265

### Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

Notes to the Group accounts – balance sheet *continued***15. Trade and other receivables**

Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt 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.

A loss on provision for bad debt 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 includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. 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 long-term contract balances for that portion of the work which has already been completed, and the remainder is included as amounts due to long-term contract customers within trade and other payables. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

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.

	<b>2013</b> <b>£m</b>	2012 £m
<b>Non-current</b>		
Pension prepayments (note 23)	<b>156</b>	47
Prepayments and accrued income <sup>1</sup>	<b>62</b>	9
US deferred compensation plan assets	<b>211</b>	187
Other receivables	<b>48</b>	11
	<b>477</b>	254
<b>Current</b>		
Long-term contract balances	<b>6,085</b>	6,521
Less: Attributable progress payments	<b>(5,526)</b>	(5,703)
Amounts due from contract customers	<b>843</b>	472
Amounts due from customers for contract work <sup>2</sup>	<b>1,402</b>	1,290
Trade receivables	<b>1,138</b>	882
Amounts owed by equity accounted investments (note 30)	<b>56</b>	163
Prepayments and accrued income <sup>1</sup>	<b>232</b>	270
Other receivables	<b>210</b>	268
	<b>3,038</b>	2,873

1 Includes £56m non-current and £39m current receivable in respect of a UK Ministry of Defence settlement agreement relating to maritime rationalisation costs charged to the income statement in 2013.

2 There are no retentions against long-term contracts (2012 £nil) and no amounts that are past due within amounts due from customers for contract work (2012 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2013 are estimated to be £31.7bn (2012 £31.4bn).

Trade receivables are disclosed net of a provision for bad debts. Disclosures relating to the ageing of trade receivables and movements in the provision for bad debts are provided in note 28. Other receivables do not contain assets which are considered to be impaired.

## 16. Other financial assets and liabilities

### 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. 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 in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately.

### Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

	2013 Assets £m	2013 Liabilities £m	2012 Assets £m	2012 Liabilities £m
<b>Non-current</b>				
Cash flow hedges – foreign exchange contracts	42	(55)	25	(66)
Other foreign exchange/interest rate contracts	–	(4)	15	–
Debt-related derivative financial instruments – assets <sup>1</sup>	–	–	22	–
	<b>42</b>	<b>(59)</b>	62	(66)
<b>Current</b>				
Cash flow hedges – foreign exchange contracts	60	(59)	32	(58)
Other foreign exchange/interest rate contracts	15	(22)	32	(30)
Debt-related derivative financial instruments – assets <sup>1</sup>	6	–	–	–
	<b>81</b>	<b>(81)</b>	64	(88)

1 Includes fair value hedges of £6m (2012 £13m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 21).

### 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 credited to the hedging reserve in respect of cash flow hedges were £53m (2012 debit £21m), including £29m on reclassification to profit and loss on maturity and £24m on contracts held at 31 December 2013.

### Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £7m (2012 £2m). The gain arising in the income statement on the fair value of the underlying hedged items was £7m (2012 £2m). There was no ineffective portion recognised in the income statement arising from fair value hedges (2012 nil).

Notes to the Group accounts – balance sheet *continued***17. Deferred tax**

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different taxable entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

**Deferred tax assets/(liabilities)**

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m
Property, plant and equipment	20	7	(82)	(88)	(62)	(81)
Intangible assets	–	–	(45)	(91)	(45)	(91)
Provisions and accruals	308	317	–	–	308	317
Goodwill	–	–	(221)	(186)	(221)	(186)
Pension/retirement schemes:						
Deficits	692	1,144	–	–	692	1,144
Additional contributions and other <sup>1</sup>	124	137	–	–	124	137
Share-based payments	19	16	–	–	19	16
Financial instruments	7	19	(6)	(11)	1	8
Other items	59	62	–	–	59	62
Rolled over capital gains	–	–	(13)	(15)	(13)	(15)
Capital losses carried forward	13	15	–	–	13	15
Trading losses carried forward	19	36	–	–	19	36
<b>Deferred tax assets/(liabilities)</b>	<b>1,261</b>	<b>1,753</b>	<b>(367)</b>	<b>(391)</b>	<b>894</b>	<b>1,362</b>
Set off of tax	(360)	(378)	360	378	–	–
<b>Net deferred tax assets/(liabilities)</b>	<b>901</b>	<b>1,375</b>	<b>(7)</b>	<b>(13)</b>	<b>894</b>	<b>1,362</b>

1 Includes deferred tax assets on US deferred compensation plans.

## 17. Deferred tax (continued)

## Movement in temporary differences during the year

	At 1 January 2013 £m	Foreign exchange adjustments £m	Acquisitions and disposals £m	Recognised in income £m	Recognised in equity £m	At 31 December 2013 £m
Property, plant and equipment	(81)	1	(1)	19	–	<b>(62)</b>
Intangible assets	(91)	(1)	–	44	3	<b>(45)</b>
Provisions and accruals	317	(11)	(1)	3	–	<b>308</b>
Goodwill	(186)	6	–	(41)	–	<b>(221)</b>
Pension/retirement schemes:						
Deficits	1,144	8	–	5	(465)	<b>692</b>
Additional contributions and other <sup>1</sup>	137	(2)	–	6	(17)	<b>124</b>
Share-based payments	16	–	–	–	3	<b>19</b>
Financial instruments	8	–	–	8	(15)	<b>1</b>
Other items	62	(4)	–	1	–	<b>59</b>
Rolled over capital gains	(15)	–	–	2	–	<b>(13)</b>
Capital losses carried forward	15	–	–	(2)	–	<b>13</b>
Trading losses carried forward	36	(4)	–	(13)	–	<b>19</b>
	<b>1,362</b>	<b>(7)</b>	<b>(2)</b>	<b>32</b>	<b>(491)</b>	<b>894</b>

	At 1 January 2012 £m	Foreign exchange adjustments £m	Acquisitions and disposals <sup>2</sup> £m	Recognised in income £m	Recognised in equity £m	At 31 December 2012 £m
Property, plant and equipment	(106)	4	1	20	–	(81)
Intangible assets	(176)	4	9	64	8	(91)
Provisions and accruals	367	(13)	(2)	(35)	–	317
Goodwill	(151)	7	(3)	(39)	–	(186)
Pension/retirement schemes:						
Deficits <sup>3</sup>	1,239	(12)	–	(23)	(60)	1,144
Additional contributions and other <sup>1</sup>	101	(5)	–	6	35	137
Share-based payments	11	(1)	–	4	2	16
Financial instruments	13	(2)	–	(7)	4	8
Other items	38	(1)	–	25	–	62
Rolled over capital gains	(16)	–	–	1	–	(15)
Capital losses carried forward	16	–	–	(1)	–	15
Trading losses carried forward	47	(2)	(1)	(8)	–	36
	<b>1,383</b>	<b>(21)</b>	<b>4</b>	<b>7</b>	<b>(11)</b>	<b>1,362</b>

1 Includes deferred tax assets on US deferred compensation plans.

2 Includes net deferred tax liabilities on disposal of subsidiaries (£6m) and the transfer of net deferred tax assets to held for sale (Safariland £2m).

3 Restated on adoption of the revised IAS 19, Employee Benefits.



Notes to the Group accounts – balance sheet *continued***17. Deferred tax (continued)****Unrecognised deferred tax assets**

Deferred tax assets have not been recognised in respect of the following items:

	<b>2013</b> <b>£m</b>	2012 £m
Deductible temporary differences, including tax credits	<b>1</b>	3
Capital losses carried forward	<b>36</b>	59
Trading and other losses carried forward	<b>62</b>	68
	<b>99</b>	130

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.

**Future changes in tax rates**

The UK current tax rate was reduced from 24% to 23% with effect from 1 April 2013. Under the Finance Act 2013, the UK current tax rate will reduce to 21% with effect from 1 April 2014, and then to 20% with effect from 1 April 2015. This will reduce future current tax charges accordingly.

The reduction from 23% to 20% was substantively enacted before 31 December 2013. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income. Accordingly, both recognised and unrecognised UK deferred tax balances as at 31 December 2013 have been calculated at 20%.

## 18. Inventories

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

	2013 £m	2012 £m
Short-term work-in-progress	381	385
Raw materials and consumables	227	203
Finished goods and goods for resale	72	67
	<b>680</b>	655

The Group recognised £4m (2012 £10m) as a write down of inventories to net realisable value.

## 19. Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term 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.

	2013 £m	2012 £m
Cash	460	657
Short-term deposits	1,762	2,698
	<b>2,222</b>	3,355

## 20. Geographical analysis of assets

### Analysis of non-current assets by geographical location

Asset location	Notes	2013 £m	2012 £m
UK		2,705	2,402
Rest of Europe		667	707
Saudi Arabia		453	615
US		8,078	9,464
Australia		494	599
Rest of Asia and Pacific		1	4
Africa, Central and South America		15	21
<b>Non-current segment assets</b>		<b>12,413</b>	13,812
Financial instruments	16	117	104
Inventories	18	680	655
Trade and other receivables	15	3,038	2,873
<b>Total segment assets</b>		<b>16,248</b>	17,444
Tax		909	1,386
Pension prepayments	23	156	47
Assets held for sale	7	140	20
Cash (as defined by the Group) <sup>1</sup>	10	2,228	3,377
<b>Consolidated total assets</b>		<b>19,681</b>	22,274

1. Includes cash and cash equivalents (note 19) and debt-related derivative financial instrument assets (note 16).

Notes to the Group accounts – balance sheet *continued***21. 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 either amortised cost or, where hedge accounting has been adopted, fair value in respect of the hedged risk. Any difference between the amount initially recognised and the redemption value is recognised in the income statement over the period of the borrowings on an effective interest basis.

	<b>2013</b> <b>£m</b>	2012 £m
<b>Non-current</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	–	100
US\$500m 4.95% bond, repayable 2014	–	308
US\$750m 5.2% bond, repayable 2015	<b>453</b>	459
US\$350m 3.5% bond, repayable 2016	<b>211</b>	214
Albertville Hangar Bond, repayable 2018	<b>6</b>	6
US\$1bn 6.375% bond, repayable 2019	<b>607</b>	626
US\$500m 4.75% bond, repayable 2021	<b>301</b>	307
£400m 4.125% bond, repayable 2022	<b>397</b>	397
US\$500m 7.5% bond, repayable 2027	<b>299</b>	306
US\$400m 5.8% bond, repayable 2041	<b>238</b>	243
Debt-related derivative financial instruments – liabilities	<b>12</b>	1
	<b>2,524</b>	2,967
<b>Current</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	<b>100</b>	–
US\$500m 4.95% bond, repayable 2014	<b>302</b>	–
Overdrafts	–	21
	<b>402</b>	21

The US\$500m 4.95% bond, repayable 2014, was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2013 of 2.4%.

The US\$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and June 2019, and give an effective rate during 2013 of 5.3%. US\$500m of this bond is measured at fair value.

The US\$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising cross-currency swaps and has an effective interest rate of 7.8%.

The debt-related derivative financial instruments represent the fair value of interest rate and cross-currency derivatives relating to 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.

## 22. Trade and other payables

Trade and other payables are stated at their cost.

	2013 £m	2012 £m
<b>Non-current</b>		
Amounts due to long-term contract customers	699	988
Accruals and deferred income	39	46
US deferred compensation plan liabilities	237	222
Other payables	185	225
	<b>1,160</b>	1,481
<b>Current</b>		
Amounts due to long-term contract customers	4,023	4,457
Amounts due to other customers	232	242
Cash received on customers' account <sup>1</sup>	1	2
Trade payables	651	710
Amounts owed to equity accounted investments (note 30)	563	708
Other taxes and social security costs	82	63
Accruals and deferred income <sup>2</sup>	1,019	1,291
Other payables	503	594
	<b>7,074</b>	8,067
Included above:		
Amounts due to long-term contract customers	4,722	5,445
Advances from long-term contract customers, including progress payments in respect of work not yet performed	4,498	5,132

- 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 2012 included £131m in respect of the settlement reached on the terminated Trinidad and Tobago contract for Offshore Patrol Vessels which was paid in 2013.

# Notes to the Group accounts – balance sheet *continued*

## 23. Retirement benefit obligations

### Defined contribution pension schemes

Obligations for contributions are recognised as an expense in the income statement as incurred.

### Defined benefit pension schemes

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 the consolidated statement of comprehensive income in the period in which they occur. Past service costs resulting from a plan amendment or curtailment are recognised immediately in the income statement.

The retirement benefit obligation recognised in the Group's balance sheet represents the present value of the defined benefit obligations calculated using a number of actuarial assumptions as set out on page 164 reduced by the fair value of scheme assets.

Certain of the Group's equity accounted investments participate in the Group's defined benefit schemes as well as Airbus SAS, the Group's share of which was disposed of in 2006. As these schemes are multi-employer schemes, the Group has allocated a share of the IAS 19, Employee Benefits, pension deficit to its equity accounted investments and other participating employers using a consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The allocation method for all schemes is based on the BAE Systems Pension Scheme's (Main Scheme) schedule of contributions agreed with the sponsoring employers and trustees as part of the triennial funding valuations performed in 2011. The next funding valuations will be performed in 2014 and, accordingly, the schedule of contributions and resultant allocation method will be agreed at that time. 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.

### Pension schemes

#### Background

BAE Systems plc operates pension schemes for the Group's qualifying employees in the UK, US and other countries. The principal schemes in the UK and US are funded defined benefit schemes, and the assets are held in separate trustee administered funds. The two largest funded defined benefit schemes are the Main Scheme and the BAE Systems 2000 Pension Plan (2000 Plan) which, in aggregate, represent 72% (2012 70%) of the total IAS 19 defined benefit obligation at 31 December 2013. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2013, the weighted average durations of the UK and US defined benefit pension obligations were 18 years (2012 18 years) and 12 years (2012 12 years), respectively.

The split of the defined benefit pension obligations on a funding basis between active, deferred and pensioner members for the Main Scheme, 2000 Plan and US schemes in aggregate is set out below:

	Active	Deferred	Pensioner
Main Scheme <sup>1</sup>	35%	15%	50%
2000 Plan <sup>2</sup>	14%	26%	60%
US schemes <sup>3</sup>	38%	19%	43%

1. Source: Main Scheme Actuarial Valuation Report as at 31 March 2011.

2. Source: 2000 Plan Actuarial Valuation Report as at 31 March 2011.

3. Source: Annual updates of the US schemes as at 1 January 2013.

### Regulatory framework

The funded UK schemes are registered and subject to the statutory scheme-specific funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and the Group.

The funded US schemes are tax-qualified pension schemes regulated by the Pension Protection Act 2006 and insured by the Pension Benefit Guarantee Corporation up to certain limits. These schemes were established under and are governed by the US Employee Retirement Income Security Act 1974 and the BAE Systems Administrative Committee is a named fiduciary with the authority to manage their operation.

### Benefits

The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The Normal Retirement Age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: [www.baesystemspensions.com](http://www.baesystemspensions.com).

The US defined benefit schemes ceased to be final salary schemes in January 2013. The benefits accrued based on the final salaries of members at that point will become payable on retirement. The Normal Retirement Age for the largest scheme in the US is 65.



## 23. Retirement benefit obligations (continued)

### Funding

The majority of the UK and US defined benefit pension schemes are funded by the Group's subsidiaries, equity accounted investments and other participating employers. The individual pension schemes' funding requirements are based on actuarial measurement frameworks set out in their funding policies.

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

The separate actuarial valuations for funding purposes include assumptions which may differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 164. The latest funding valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2011 and showed a funding deficit of £3bn. Deficit recovery plans agreed with the trustees of both schemes run until 2026.

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

The total Group contributions made to the defined benefit schemes in the year ended 31 December 2013 were £560m (2012 £1,029m) excluding those amounts allocated to equity accounted investments and participating employers of £86m (2012 £128m). This includes additional contributions of £44m into the UK schemes relating to the share buyback programme (2012 £nil).

In 2014, the Group expects to make regular contributions at a similar level to the recurring contributions made in 2013 and additional contributions, such that total deficit funding, in excess of service cost, is expected to be approximately £0.4bn.

The Group incurred a charge in respect of cash contributions of £130m (2012 £129m) paid to defined contribution schemes for employees.

### Risk management

The defined benefit pension schemes expose the Group to actuarial risks, including market (investment) risk, interest rate risk, inflation risk and longevity risk.

Risk	Mitigation
<b>Market (investment) risk</b> Asset returns may not move in line with the liabilities and may be subject to volatility.	<p>The investment portfolios are highly diversified, investing in a wide range of assets, in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities.</p> <p>Some 50% (2012 52%) of the Group's pension scheme assets are held in equities and pooled investment vehicles due to the higher expected level of return over the long term.</p> <p>Some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of market risk. In August 2013, the Main Scheme implemented a long-dated equity option strategy protecting £1.4bn of assets against a significant fall in equity markets.</p>
<b>Interest rate risk</b> Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	<p>In addition to investing in bonds as part of the matching portfolio, the principal UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk.</p>
<b>Inflation risk</b> Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	<p>In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk.</p> <p>During the year, the Main Scheme implemented a pension increase exchange exercise to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases. The effective date of the exercise is 1 May 2014.</p>
<b>Longevity risk</b> Liabilities are sensitive to life expectancy, with increases in life expectancy leading to an increase in the valuation of liabilities.	<p>Longevity Adjustment Factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees.</p> <p>In February 2013, with the agreement of the Company, the trustees of the 2000 Plan entered into an arrangement with Legal &amp; General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. In December 2013, similar arrangements were entered into, with Legal &amp; General, by the trustees of the Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme, covering £0.9bn and £0.8bn of pension scheme liabilities, respectively. These arrangements will reduce the funding volatility relating to increasing life expectancy.</p>

Notes to the Group accounts – balance sheet *continued***23. Retirement benefit obligations (continued)****Principal actuarial assumptions**

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.

	UK			US		
	2013	2012	2011	2013	2012	2011
<b>Financial assumptions</b>						
Discount rate (%)	<b>4.5</b>	4.5	4.8	<b>4.9</b>	4.1	5.0
Inflation (%)	<b>3.4</b>	2.9	2.9	<b>n/a</b>	n/a	n/a
Rate of increase in salaries (%)	<b>3.4</b>	3.4	3.4	<b>3.0</b>	3.7	4.5
Rate of increase in pensions in payment (%)	<b>1.9 – 3.7</b>	1.8 – 3.5	1.9 – 3.4	<b>n/a</b>	n/a	n/a
Rate of increase in deferred pensions (%)	<b>2.5/3.4</b>	2.3/2.9	2.0/2.9	<b>n/a</b>	n/a	n/a
<b>Demographic assumptions</b>						
Life expectancy of a male currently aged 65 (years)	<b>87 – 89</b>	87 – 89	87 – 89	<b>84</b>	84	84
Life expectancy of a female currently aged 65 (years)	<b>89 – 90</b>	89 – 90	89 – 90	<b>86</b>	86	86
Life expectancy of a male currently aged 45 (years)	<b>88 – 90</b>	88 – 90	88 – 90	<b>84</b>	84	84
Life expectancy of a female currently aged 45 (years)	<b>91 – 92</b>	91 – 92	91 – 92	<b>86</b>	86	86

**Discount rate**

Discount rate assumptions are based on third-party AA corporate bond indices and yields that reflect the maturity profile of the expected benefit payments.

**Inflation**

In the UK, the inflation assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information. In the US, inflation assumptions are not significant as the Group's US pension schemes are not indexed with inflation.

**Rate of increase in salaries**

The rate of increase in salaries for the UK schemes is assumed to be Retail Prices Index (RPI) inflation of 3.4% (2012 0.5% above RPI inflation of 2.9%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

**Rate of increase in pensions in payment**

The rate of increase in pensions in payment differs between UK schemes. Different tranches of the schemes increase at rates based on either RPI or Consumer Prices Index (CPI) inflation, and some are subject to an inflation cap. With the exception of two smaller schemes, the rate of increase in pensions in payment is based on RPI inflation.

**Rate of increase in deferred pensions**

The rate of increase in deferred pensions for the UK schemes is based on CPI inflation of 2.5% (2012 2.3%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.4% (2012 2.9%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

**Life expectancy**

For its UK pension schemes, the Group has used the Self-Administered Pension Schemes S1 mortality tables based on year of birth (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 scheme members. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2010 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1%, for both pensioner and non-pensioner members.

The mortality tables used for the US pension arrangements as calculated at 31 December 2012 are the 2013 IRS Static Tables, which are projected to 2020 for pensioners and to 2028 for non-pensioners using Scale AA. The mortality tables used for the US pension arrangements as calculated at 31 December 2013 are the 2014 IRS Static Tables, which are projected to 2021 for pensioners and to 2029 for non-pensioners using Scale AA.

**Post-retirement benefits other than pensions****Background**

The Group operates a number of non-pension post-retirement benefit schemes, 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 schemes, covering retiree medical and life insurance schemes in certain US subsidiaries, were performed by independent actuaries as at 1 January 2013. These valuations were rolled forward to reflect the information at 31 December 2013. The method of accounting for these is similar to that used for defined benefit pension schemes.

**Principal actuarial assumptions**

The assumption for long-term healthcare cost increases is 5.3% (2012 5.2%) based on the assumptions that the increases are 8.3% in 2014 reducing to 5% by 2023 and 5% each year thereafter for pre-retirement, and 7.75% in 2014 reducing to 5% by 2023 and 5% each year thereafter for post-retirement.

## 23. Retirement benefit obligations (continued)

The disclosures below relate to post-retirement benefit schemes in the UK, US and other countries which are accounted for as defined benefit schemes in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries as updated to take account of the requirements of IAS 19 to assess the deficits of the schemes at 31 December each year.

### Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total IAS 19 deficit at 1 January 2013	(4,795)	(913)	(5,708)
Actual return on assets excluding amounts included in interest expense	1,190	214	1,404
(Increase)/decrease in liabilities due to changes in assumptions and experience	(750)	351	(399)
Additional contributions in excess of service cost	232	–	232
Recurring contributions in excess of service cost	62	95	157
Past service cost – plan amendments	(11)	–	(11)
Net interest expense	(200)	(29)	(229)
Foreign exchange adjustments	–	(20)	(20)
Movement in US healthcare schemes	–	36	36
<b>Total IAS 19 deficit at 31 December 2013</b>	<b>(4,272)</b>	<b>(266)</b>	<b>(4,538)</b>
Allocated to equity accounted investments and other participating employers	1,029	–	1,029
<b>Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers at 31 December 2013</b>	<b>(3,243)</b>	<b>(266)</b>	<b>(3,509)</b>

The net increase in UK liabilities due to changes in assumptions and experience reflects a 0.5 percentage point reduction in the real discount rate to 1.1%, partially offset by the rate of increase in salaries being held at RPI inflation of 3.4% (2012 0.5% above RPI inflation of 2.9%).

### Amounts recognised on the balance sheet

The bid values of scheme assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present values of scheme liabilities, which are derived from cash flow projections over long periods and therefore inherently uncertain, as at 31 December are shown in the following tables.

	2013				2012			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Present value of unfunded obligations	(53)	(130)	–	(183)	(53)	(142)	(5)	(200)
Present value of funded obligations	(22,550)	(3,210)	(117)	(25,877)	(21,353)	(3,609)	(129)	(25,091)
Fair value of scheme assets	18,331	3,043	148	21,522	16,611	2,843	129	19,583
Total IAS 19 (deficit)/surplus, net	(4,272)	(297)	31	(4,538)	(4,795)	(908)	(5)	(5,708)
Allocated to equity accounted investments and other participating employers	1,029	–	–	1,029	1,148	–	–	1,148
<b>Group's share of IAS 19 (deficit)/surplus, net</b>	<b>(3,243)</b>	<b>(297)</b>	<b>31</b>	<b>(3,509)</b>	<b>(3,647)</b>	<b>(908)</b>	<b>(5)</b>	<b>(4,560)</b>
Represented by:								
Pension prepayments (within trade and other receivables)	79	41	36	156	–	38	9	47
Retirement benefit obligations	(3,322)	(338)	(5)	(3,665)	(3,647)	(946)	(14)	(4,607)
	(3,243)	(297)	31	(3,509)	(3,647)	(908)	(5)	(4,560)
<b>Group's share of IAS 19 deficit of equity accounted investments</b>	<b>(115)</b>	<b>–</b>	<b>–</b>	<b>(115)</b>	<b>(137)</b>	<b>–</b>	<b>–</b>	<b>(137)</b>

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £3.9bn (2012 £4.8bn).

Notes to the Group accounts – balance sheet *continued***23. Retirement benefit obligations (continued)****Changes in the fair value of scheme assets before allocation to equity accounted investments and other participating employers**

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Value of scheme assets at 1 January 2012	15,010	2,567	130	17,707
<i>Interest income<sup>1</sup></i>	734	127	6	867
<i>Actual return on assets excluding amounts included in interest income<sup>1</sup></i>	601	292	2	895
Actual return on assets <sup>1</sup>	1,335	419	8	1,762
<i>Contributions by employer</i>	1,021	136	4	1,161
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	99	–	–	99
Total contributions by employer	1,120	136	4	1,260
Members' contributions (including Department for Work and Pensions rebates)	23	14	–	37
Administrative expenses <sup>1</sup>	(32)	(10)	–	(42)
Foreign exchange loss	–	(119)	(6)	(125)
Benefits paid	(845)	(164)	(7)	(1,016)
Value of scheme assets at 31 December 2012	16,611	2,843	129	19,583
<i>Interest income</i>	745	123	5	873
<i>Actual return on assets excluding amounts included in interest income</i>	1,190	214	23	1,427
Actual return on assets	1,935	337	28	2,300
<i>Contributions by employer</i>	529	117	2	648
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	104	–	–	104
Total contributions by employer	633	117	2	752
Members' contributions (including Department for Work and Pensions rebates)	13	–	–	13
Administrative expenses	(30)	(10)	–	(40)
Foreign exchange loss	–	(69)	(6)	(75)
Benefits paid	(831)	(175)	(5)	(1,011)
<b>Value of scheme assets at 31 December 2013</b>	<b>18,331</b>	<b>3,043</b>	<b>148</b>	<b>21,522</b>

1 Restated on adoption of the revised IAS 19, Employee Benefits.

## 23. Retirement benefit obligations (continued)

### Assets of defined benefit pension schemes

	2013								
	UK			US			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK <sup>1</sup>	4,139	–	4,139	–	–	–	4,139	–	4,139
Overseas	2,909	–	2,909	788	–	788	3,697	–	3,697
Pooled investment vehicles <sup>2</sup>	2,064	374	2,438	340	–	340	2,404	374	2,778
Fixed interest securities:									
UK gilts	2,261	–	2,261	–	–	–	2,261	–	2,261
UK corporates	2,081	–	2,081	–	–	–	2,081	–	2,081
Overseas government	103	–	103	172	–	172	275	–	275
Overseas corporates	205	–	205	1,514	–	1,514	1,719	–	1,719
Index-linked securities:									
UK gilts	1,822	–	1,822	–	–	–	1,822	–	1,822
UK corporates	1,120	–	1,120	–	–	–	1,120	–	1,120
Property <sup>3</sup>	1,043	176	1,219	–	184	184	1,043	360	1,403
Derivatives	–	(315)	(315)	–	–	–	–	(315)	(315)
Cash:									
Sterling	242	–	242	–	–	–	242	–	242
Foreign currency	65	–	65	37	–	37	102	–	102
Other	4	38	42	–	8	8	4	46	50
<b>Total</b>	<b>18,058</b>	<b>273</b>	<b>18,331</b>	<b>2,851</b>	<b>192</b>	<b>3,043</b>	<b>20,909</b>	<b>465</b>	<b>21,374</b>

	2012								
	UK			US			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK <sup>1</sup>	3,502	–	3,502	–	–	–	3,502	–	3,502
Overseas	2,631	–	2,631	1,077	–	1,077	3,708	–	3,708
Pooled investment vehicles <sup>2</sup>	2,520	–	2,520	456	–	456	2,976	–	2,976
Fixed interest securities:									
UK gilts	1,789	–	1,789	–	–	–	1,789	–	1,789
UK corporates	1,907	–	1,907	–	–	–	1,907	–	1,907
Overseas government	23	–	23	82	–	82	105	–	105
Overseas corporates	199	–	199	1,027	–	1,027	1,226	–	1,226
Index-linked securities:									
UK gilts	2,262	–	2,262	–	–	–	2,262	–	2,262
UK corporates	530	–	530	–	–	–	530	–	530
Property <sup>3</sup>	967	169	1,136	–	170	170	967	339	1,306
Derivatives	–	(256)	(256)	–	–	–	–	(256)	(256)
Cash:									
Sterling	296	–	296	–	–	–	296	–	296
Foreign currency	20	–	20	27	–	27	47	–	47
Other	–	52	52	–	4	4	–	56	56
<b>Total</b>	<b>16,646</b>	<b>(35)</b>	<b>16,611</b>	<b>2,669</b>	<b>174</b>	<b>2,843</b>	<b>19,315</b>	<b>139</b>	<b>19,454</b>

1 Includes £32m of the Company's own ordinary shares (2012 £25m).

2 Primarily comprises equities.

3 Includes £259m of property occupied by Group companies (2012 £255m).



Notes to the Group accounts – balance sheet *continued***23. Retirement benefit obligations (continued)**

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Defined benefit obligations at 1 January 2012	(19,686)	(3,460)	(146)	(23,292)
<i>Current service cost</i>	(178)	(44)	(2)	(224)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(99)	–	–	(99)
Total current service cost	(277)	(44)	(2)	(323)
Members' contributions (including Department for Work and Pensions rebates)	(23)	(14)	–	(37)
Past service cost – plan amendments	(26)	(1)	(3)	(30)
Actuarial loss due to changes in financial assumptions <sup>1</sup>	(1,272)	(388)	(9)	(1,669)
Actuarial (loss)/gain due to changes in demographic assumptions <sup>1</sup>	–	(38)	2	(36)
Experience (losses)/gains <sup>1</sup>	(35)	10	1	(24)
Curtailment gains	–	26	16	42
Interest expense	(932)	(163)	(6)	(1,101)
Foreign exchange gain	–	157	6	163
Benefits paid	845	164	7	1,016
Defined benefit obligations at 31 December 2012	(21,406)	(3,751)	(134)	(25,291)
<i>Current service cost</i>	(205)	(12)	(1)	(218)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(104)	–	–	(104)
Total current service cost	(309)	(12)	(1)	(322)
Members' contributions (including Department for Work and Pensions rebates)	(13)	–	–	(13)
Past service cost – plan amendments	(11)	–	–	(11)
Actuarial (loss)/gain due to changes in financial assumptions	(896)	330	11	(555)
Experience gains	146	21	5	172
Interest expense	(945)	(152)	(5)	(1,102)
Foreign exchange gain	–	49	2	51
Benefits paid	831	175	5	1,011
<b>Defined benefit obligations at 31 December 2013</b>	<b>(22,603)</b>	<b>(3,340)</b>	<b>(117)</b>	<b>(26,060)</b>

1 Restated on adoption of the revised IAS 19, Employee Benefits.

## 23. Retirement benefit obligations (continued)

### Sensitivity analysis

Changes in the following principal actuarial assumptions would have the following effect on the defined benefit pension obligation:

	(Increase)/decrease £bn
Discount rate:	
0.1 percentage point increase	0.4
0.1 percentage point decrease	(0.4)
Inflation:	
0.1 percentage point increase	(0.4)
0.1 percentage point decrease	0.4
Life expectancy:	
One-year increase	(0.9)
One-year decrease	0.9

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2013 and keeping all other assumptions as set out on page 164.

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/decrease £bn
Inflation:	
0.5 percentage point increase	(1.5)
0.5 percentage point decrease	1.5
1.0 percentage point increase	(2.9)
1.0 percentage point decrease	2.9

Three of the Group's schemes are invested in longevity swap arrangements insuring against longevity risk for the current pensioner population (see page 163). As life expectancy changes, the value of those longevity arrangements included within scheme assets will offset any movement in the defined benefit obligation in respect of the relevant pensioners. Allowing for a change in scheme assets from the movement in the value of the longevity arrangements, a one-year increase/decrease in life expectancy would increase/decrease the Group's net pension deficit by £0.8bn.

### Amounts recognised in the income statement after allocation to equity accounted investments and other participating employers

	2013				Restated <sup>1</sup> 2012			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
<b>Included in operating costs:</b>								
Current service cost	(160)	(12)	(1)	(173)	(141)	(44)	(2)	(187)
Past service cost – plan amendments	(11)	–	–	(11)	(26)	(1)	(3)	(30)
	(171)	(12)	(1)	(184)	(167)	(45)	(5)	(217)
Administrative expenses	(24)	(10)	–	(34)	(29)	(10)	–	(39)
	(195)	(22)	(1)	(218)	(196)	(55)	(5)	(256)
<b>Included in other income:</b>								
Pension curtailment gains	–	–	–	–	–	26	–	26
US healthcare curtailment gains	–	–	–	–	–	–	16	16
	–	–	–	–	–	26	16	42
<b>Included in finance costs:</b>								
Net interest expense on retirement benefit obligations	(157)	(29)	–	(186)	(151)	(36)	–	(187)
<b>Included in share of results of equity accounted investments:</b>								
Group's share of equity accounted investments' operating costs	(9)	–	–	(9)	(7)	–	–	(7)
Group's share of equity accounted investments' finance costs	(5)	–	–	(5)	(7)	–	–	(7)

1 On adoption of the revised IAS 19, Employee Benefits.

# Notes to the Group accounts – balance sheet *continued*

## 24. 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.

### 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. 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.

### Reorganisations

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. The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Future operating costs are not provided for.

### Legal, contractual and environmental

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.

### Other

Other provisions include provisions for onerous contracts, which are 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.

	Warranties and after-sales service £m	Reorganisations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	66	19	294	70	449
Current	64	54	137	42	297
At 1 January 2013	130	73	431	112	746
Created <sup>1</sup>	60	113	90	64	327
Released	(38)	(25)	(48)	(13)	(124)
Utilised	(47)	(38)	(51)	(19)	(155)
Discounting	–	–	7	2	9
Foreign exchange adjustments	(3)	(1)	(4)	(1)	(9)
<b>At 31 December 2013</b>	<b>102</b>	<b>122</b>	<b>425</b>	<b>145</b>	<b>794</b>
Represented by:					
Non-current	55	41	232	75	403
Current	47	81	193	70	391
	<b>102</b>	<b>122</b>	<b>425</b>	<b>145</b>	<b>794</b>

1 Reorganisation provisions created in 2013 include £95m for which the Group is contractually entitled to re-imbursement from the UK Ministry of Defence (see note 15).

### Warranties and after-sales service

Warranty and after-sales service 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

Reorganisation 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

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

### Other

Other includes a provision taken in 2013 in respect of the Radford Army Ammunition Plant contract. There are no other individually significant provisions included within other provisions.

## 25. 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
<b>Issued and fully paid</b>					
At 1 January 2012 and 1 January 2013	3,588	90	1	1	90
Repurchased and cancelled	(52)	(1)	–	–	(1)
<b>At 31 December 2013</b>	<b>3,536</b>	<b>89</b>	<b>1</b>	<b>1</b>	<b>89</b>

### Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

### Share buyback

In 2013, 51,595,000 ordinary shares of 2.5p were repurchased under the buyback programme (2012 nil).

### Treasury shares

As at 31 December 2013, 327,644,952 (2012 336,813,996) ordinary shares of 2.5p each with an aggregate nominal value of £8,191,124 (2012 £8,420,350) were held in treasury. During 2013, 9,169,044 treasury shares were used to satisfy awards and options under the Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan (2012 14,942,858 in respect of the Share Incentive Plan, Share Matching Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan).

### Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

### BAE Systems ESOP Trust

The Group has an Employee Share Option Plan (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 2013.

At 31 December 2013, the ESOP held 1,451,631 (2012 2,633,198) ordinary shares of 2.5p each with a market value of £6m (2012 £9m). 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.

Dividend waivers were in operation for the dividends paid in June and December 2013 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants. A dividend waiver was also in operation for the dividends paid in June and December 2013 over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

### Equity 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.

	2013 £m	2012 £m
Prior year final 11.7p dividend per ordinary share paid in the year (2012 11.3p)	380	367
Interim 8.0p dividend per ordinary share paid in the year (2012 7.8p)	258	253
	<b>638</b>	<b>620</b>

After the balance sheet date, the directors proposed a final dividend of 12.1p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 2 June 2014 to shareholders registered on 22 April 2014. The ex-dividend date is 16 April 2014.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 9 May 2014.

Notes to the Group accounts – balance sheet *continued***25. Share capital and other reserves (continued)****Other reserves**

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Capital redemption reserve £m	Total £m
At 1 January 2012	4,589	202	10	572	8	–	5,381
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	(164)	–	–	(164)
Equity accounted investments	–	–	–	(25)	–	–	(25)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(97)	–	–	(97)
Amounts charged to hedging reserve	–	–	–	–	(21)	–	(21)
Tax on other comprehensive income	–	–	–	–	5	–	5
At 1 January 2013	4,589	202	10	286	(8)	–	5,079
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	(240)	–	–	(240)
Equity accounted investments	–	–	–	(3)	–	–	(3)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(8)	–	–	(8)
Amounts credited to hedging reserve	–	–	–	–	53	–	53
Tax on other comprehensive income	–	–	–	–	(14)	–	(14)
Net purchase of own shares	–	–	–	–	–	1	1
<b>At 31 December 2013</b>	<b>4,589</b>	<b>202</b>	<b>10</b>	<b>35</b>	<b>31</b>	<b>1</b>	<b>4,868</b>

**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, 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.

**Revaluation reserve**

The revaluation reserve relates to the revaluation at fair value of the net assets of the BVT joint venture previously held as an equity accounted investment 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.

**Capital redemption reserve**

The capital redemption reserve represents the cumulative nominal value of the Company's ordinary shares repurchased and subsequently cancelled. During the year ended 31 December 2013, 51,595,000 ordinary shares with a nominal value of £1m were repurchased and have been subsequently cancelled.

**Capital**

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

At 31 December 2013, the Group's capital was £3,387m (2012 £3,782m), which comprises total equity of £3,418m (2012 £3,774m), excluding amounts accumulated in equity relating to cash flow hedges of £31m (2012 £8m debit). Net debt (as defined by the Group) was £699m (2012 net cash £387m).

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 and ensure operating flexibility, whilst:

- meeting its pension obligations;
- continuing to pursue organic investment opportunities;
- paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings (see note 8);
- making accelerated returns of capital to shareholders when the balance sheet allows; and
- investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.



## Notes to the Group accounts – other information

### 26. Acquisition and disposal of subsidiaries

#### Business combinations on or after 1 January 2010 (IFRS 3, Business Combinations)

Business combinations are accounted for using the acquisition method as at the acquisition date, which is the date on which control is transferred to the Group. The Group measures goodwill as the acquisition-date fair value of the consideration transferred, including the amount of any non-controlling interest in the acquiree, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed, including contingent liabilities as required by IFRS 3.

Consideration transferred includes the fair values of assets transferred, liabilities incurred by the Group to the previous owners of the acquiree, equity interests issued by the Group, contingent consideration, and share-based payment awards of the acquiree that are replaced in the business combination. Any contingent consideration payable is recognised at fair value at the acquisition date. Subsequent changes to the fair value of contingent consideration that is not classified as equity are recognised in the income statement. If a business combination results in the termination of pre-existing relationships between the Group and the acquiree, then the lower of the termination amount, as contained in the agreement, and the value of the off-market element, is deducted from the consideration transferred and recognised in other expenses.

Transaction costs that the Group incurs in connection with a business combination, such as finder's fees, legal fees, due diligence fees, and other professional and consulting fees, are expensed as incurred.

Non-controlling interests are measured at either the non-controlling interest's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised or at fair value. The method used is determined on an acquisition-by-acquisition basis.

#### Accounting for the acquisition of non-controlling interests that do not result in a change in control

Acquisitions of non-controlling interests are accounted for as transactions with equity holders in their capacity as equity holders and, therefore, no goodwill or profit or loss in the income statement is recognised as a result of such transactions.

#### Subsidiaries disposed of during 2013

In February, the Group completed the sale of its Commercial Armored Vehicles LLC business in the US to The O'Gara Group, Inc. for cash consideration of approximately \$10m (£6m). A profit on disposal of Commercial Armored Vehicles of £9m, including £8m relating to the reclassification of cumulative currency translation reserve, is included in the profit on disposal of businesses of £10m (see note 4).

#### Subsidiaries disposed of during 2012

In March 2012, the Group completed the sale of its BAE Systems Safety Products Inc. and Schroth Safety Products GmbH businesses (Safety Products) in the US and Germany for cash consideration of approximately \$32m (£21m).

In July 2012, the US-based Safariland, LLC (Safariland) business was sold for cash consideration (after adjustment) of approximately \$124m (£78m).

Also in July 2012, the Group sold the assets comprising its BAE Systems Tensylon High Performance Materials Inc. (Tensylon) business for cash consideration of \$18m (£12m).

#### Summary

	Safariland £m	Other £m	Total £m
Cash consideration	78	33	111
Transaction costs paid	(1)	(2)	(3)
Cash proceeds	77	31	108
Transaction costs accrued	(1)	–	(1)
Net proceeds	76	31	107
Net assets disposed:			
Intangible assets	(23)	(12)	(35)
Property, plant and equipment	(15)	(4)	(19)
Inventories	(16)	(14)	(30)
Trade and other receivables	(22)	(3)	(25)
Deferred tax	(2)	6	4
Trade and other payables	13	2	15
Cash and cash equivalents	(10)	(1)	(11)
	(75)	(26)	(101)
Cumulative currency translation gain	84	13	97
Profit on disposal of businesses	85	18	103

Safariland and Tensylon were written down to fair value less costs to sell prior to their disposal incurring impairment charges to intangible assets of £48m and £12m, respectively.

# Notes to the Group accounts – other information *continued*

## 27. Fair value measurement

### Fair value of financial instruments

Certain of the Group's financial instruments are held at fair value.

The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date.

The fair values of financial instruments held at fair value have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair values of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair values 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 values of loans and overdrafts have 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 31 December may not be indicative of the amounts the Group would expect to realise in the current market environment.

### Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

### Carrying amounts and fair values of certain financial instruments

		2013		2012	
	Notes	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Financial instruments measured at fair value:					
Non-current					
Available-for-sale financial assets		3	3	5	5
Other receivables <sup>1</sup>	15	211	211	187	187
Other financial assets	16	42	42	62	62
Other financial liabilities	16	(59)	(59)	(66)	(66)
Loans	21	(307)	(307)	(320)	(320)
Trade and other payables <sup>1</sup>	22	(237)	(237)	(222)	(222)
Current					
Other financial assets	16	81	81	64	64
Other financial liabilities	16	(81)	(81)	(88)	(88)
Financial instruments not measured at fair value:					
Non-current					
Other receivables	15	110	110	20	20
Loans	21	(2,217)	(2,367)	(2,647)	(3,087)
Trade and other payables	22	(923)	(923)	(1,259)	(1,259)
Current					
Trade and other receivables	15	3,038	3,038	2,873	2,873
Cash and cash equivalents	19	2,222	2,222	3,355	3,355
Loans and overdrafts	21	(402)	(414)	(21)	(21)
Trade and other payables	22	(7,074)	(7,074)	(8,067)	(8,067)

1 Represents US deferred compensation plan assets and liabilities.

All of the financial assets and liabilities measured at fair value are classified as level 2 using the fair value hierarchy. There were no transfers between levels during the year.

The fair value of total loans estimated using market prices at 31 December 2013 is £3,088m (2012 £3,407m).

## 28. Financial risk management

### Interest rate risk

The Group's objective is to manage its exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, mainly interest rate swaps.

The Group's interest rate management policy is that a minimum of 50% (2012 50%) and a maximum of 90% (2012 90%) of gross debt is maintained at fixed interest rates. At 31 December 2013, the Group had 69% (2012 79%) of fixed rate debt and 31% (2012 21%) of floating rate debt based on a gross debt of £2.9bn, including debt-related derivative financial assets (2012 £3.0bn).

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	Less than one year £m	Between one and two years £m	More than two years £m
Cash and cash equivalents	2,222	–	–
Loans	(909)	(300)	(300)

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 2013, the Group had a total of \$1.5bn (2012 \$1.0bn) of this type of swap outstanding with a weighted average duration of 2.3 years (2012 1.7 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 9.6 years (2012 10.1 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.3% (2012 2.7%) on US dollars. The cost of the fixed rate debt was 5.7% (2012 5.7%).

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 £6m (2012 £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 £13m (2012 £7m).

### Liquidity risk

#### Contractual cash flows on financial liabilities

The contractual cash flows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash flows are shown on a gross basis, are not discounted and include estimated interest payments where applicable.

	31 December 2013					31 December 2012 <sup>1</sup>				
	Contractual cash flow					Contractual cash flow				
	Carrying amount £m	Less than one year £m	Between one and five years £m	More than five years £m	Total £m	Carrying amount £m	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
<b>Loans and overdrafts</b>	<b>(2,926)</b>	<b>(558)</b>	<b>(1,129)</b>	<b>(2,513)</b>	<b>(4,200)</b>	(2,988)	(187)	(1,605)	(2,657)	(4,449)
(Sale)/purchase contracts:										
US dollar		(197)	(69)	97	(169)		466	200	54	720
Euro		683	1,079	61	1,823		472	1,018	95	1,585
Sterling		(620)	(894)	(159)	(1,673)		(1,088)	(1,028)	(148)	(2,264)
Other		134	(122)	–	12		137	(199)	–	(62)
<b>Cash flow hedges – foreign exchange contracts</b>	<b>(12)</b>	<b>–</b>	<b>(6)</b>	<b>(1)</b>	<b>(7)</b>	(67)	(13)	(9)	1	(21)
Purchase/(sale) contracts:										
US dollar		809	–	–	809		(1,348)	(13)	–	(1,361)
Euro		551	–	–	551		683	–	–	683
Sterling		(1,591)	–	–	(1,591)		285	–	–	285
Other		233	–	–	233		382	15	–	397
Interest rate contracts		8	(5)	(3)	–		8	4	–	12
<b>Other foreign exchange/interest rate contracts</b>	<b>(11)</b>	<b>10</b>	<b>(5)</b>	<b>(3)</b>	<b>2</b>	17	10	6	–	16
<b>Debt-related derivative financial instruments – assets</b>	<b>6</b>	<b>6</b>	<b>–</b>	<b>–</b>	<b>6</b>	22	6	6	7	19
<b>Other financial assets and liabilities</b>	<b>(17)</b>	<b>16</b>	<b>(11)</b>	<b>(4)</b>	<b>1</b>	(28)	3	3	8	14

1. Re-presented to provide more detailed information on contractual cash flows on derivative financial instruments.

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.

# Notes to the Group accounts – other information *continued*

## 28. Financial risk management (continued)

### Borrowing facilities

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2013, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2012 £2bn). The RCF is contracted until 2018 and was undrawn throughout the year. The RCF also acts as a backstop to Commercial Paper issued by the Group. At 31 December 2013, the Group had no Commercial Paper in issue (2012 £nil).

### Cash management

Cash flow forecasting is performed by the businesses on a monthly basis. The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet operational needs and maintain adequate headroom.

Surplus cash held by the businesses 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 cash forecasts.

### Credit risk

#### Cash

The Group's objective is to monitor and control counterparty credit risk and credit limit utilisation. The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with financial institutions with the strongest credit ratings for short periods. The cash and cash equivalents balance at 31 December 2013 of £2,222m (2012 £3,355m) was invested with 27 (2012 29) financial institutions. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price. The Group has no exposure to Greek, Irish, Italian, Portuguese or Spanish banks. Additionally, the Group monitors its exposure to banks which have exposure to these countries.

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.

#### Trade receivables

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 bad debt provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk, and no one counterparty constitutes more than 5% of the balance (2012 8%).

The ageing of trade receivables is detailed below:

	2013			2012		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	919	–	919	659	–	659
Up to 180 days overdue and not impaired	153	–	153	142	–	142
Up to 180 days overdue and impaired	1	(1)	–	1	(1)	–
Past 180 days overdue and not impaired	66	–	66	81	–	81
Past 180 days overdue and impaired	26	(26)	–	30	(30)	–
	<b>1,165</b>	<b>(27)</b>	<b>1,138</b>	<b>913</b>	<b>(31)</b>	<b>882</b>

Movements on the provision for bad debts are as follows:

	2013 £m	2012 £m
At 1 January	31	39
Created	14	20
Released	(16)	(18)
Utilised	(2)	(7)
Foreign exchange adjustments	–	(1)
Other	–	(2)
<b>At 31 December</b>	<b>27</b>	<b>31</b>

### 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 from movements in foreign currency exchange rates, mainly the US dollar, Euro and Saudi Riyal.

The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. All material firm transactional exposures are hedged, unless otherwise approved as exceptions by the Treasury Review Management Committee, and the Group aims, where possible, to apply hedge accounting to these transactions.

The Group is 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 foreign subsidiaries and equity accounted investments it regards as long-term investments.

## 29. Share-based payments

The Group has granted equity-settled share options and Long-Term Incentive Plan (LTIP) arrangements, and cash-settled share appreciation rights to employees.

Equity-settled share options and LTIP arrangements 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. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number 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.

Details of the terms and conditions of each share-based payment plan are given in the Annual remuneration report on pages 92 to 104.

### Expense in year

	2013			2012		
	Equity-settled £m	Cash-settled £m	Total £m	Equity-settled £m	Cash-settled £m	Total £m
Executive Share Option Plan (ExSOP)	3	3	6	2	2	4
Performance Share Plan (PSP)	8	–	8	11	–	11
Restricted Share Plan (RSP)	7	–	7	9	–	9
Share Matching Plan (SMP)	–	–	–	2	–	2
	18	3	21	24	2	26

The Group also incurred a charge of £31m (2012 £33m) in respect of the equity-settled all-employee free shares and matching Partnership Shares elements of the Share Incentive Plan.

### ExSOP

#### Equity-settled options

	2013		2012	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	23,014	3.24	10,624	3.61
Granted during the year	12,293	3.90	15,940	3.02
Exercised during the year	(1,918)	2.37	(807)	2.29
Expired during the year	(2,430)	3.62	(2,743)	3.70
Outstanding at the end of the year	30,959	3.52	23,014	3.24
Exercisable at the end of the year	5,674	3.95	8,307	3.62

#### Cash-settled share appreciation rights

	2013		2012	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	4,063	2.20	5,243	2.19
Exercised during the year	(2,125)	2.03	(1,057)	2.14
Expired during the year	(136)	2.30	(123)	2.36
Outstanding at the end of the year	1,802	2.38	4,063	2.20
Exercisable at the end of the year	1,802	2.38	4,063	2.20

	2013		2012	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	2.01 – 4.79	2.01 – 3.58	1.72 – 4.79	1.72 – 3.56
Weighted average remaining contracted life (years)	8	1	7	2
Weighted average fair value of options granted (£)	0.61	–	0.41	–



Notes to the Group accounts – other information *continued***29. Share-based payments (continued)****PSP****Equity-settled awards**

	<b>2013</b> Number of shares '000	2012 Number of shares '000
Outstanding at the beginning of the year	<b>26,834</b>	31,698
Granted during the year	<b>5,753</b>	7,550
Exercised during the year	<b>(1,097)</b>	(2,056)
Expired during the year	<b>(9,797)</b>	(10,358)
Outstanding at the end of the year	<b>21,693</b>	26,834
Exercisable at the end of the year	<b>720</b>	416

**Cash-settled share appreciation rights**

	<b>2013</b> Number of shares '000	2012 Number of shares '000
Outstanding at the beginning of the year	–	25
Expired during the year	–	(25)
Outstanding at the end of the year	–	–
Exercisable at the end of the year	–	–

	<b>2013</b>		2012	
	<b>Equity-settled</b>	<b>Cash-settled</b>	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	<b>5</b>	–	5	–
Weighted average fair value of awards granted (£)	<b>3.51</b>	–	2.62	–

The exercise price for the PSP is £nil (2012 £nil).

**RSP**

All awards are equity-settled.

	<b>2013</b> Number of shares '000	2012 Number of shares '000
Outstanding at the beginning of the year	<b>7,519</b>	1,383
Granted during the year	<b>1,373</b>	7,310
Exercised during the year	<b>(1,887)</b>	(92)
Expired during the year	<b>(935)</b>	(1,082)
Outstanding at the end of the year	<b>6,070</b>	7,519
Exercisable at the end of the year	–	8

	<b>2013</b>	2012
Weighted average remaining contracted life (years)	<b>5</b>	6
Weighted average fair value of awards granted (£)	<b>3.90</b>	3.01

The exercise price for the RSP is £nil (2012 £nil).

## 29. Share-based payments (continued)

### SMP

All awards are equity-settled.

	2013 Number of shares '000	2012 Number of shares '000
Outstanding at the beginning of the year	13,334	16,621
Granted during the year	2,766	3,952
Exercised during the year	–	(2,521)
Expired during the year	(4,899)	(4,718)
Outstanding at the end of the year	11,201	13,334
Exercisable at the end of the year	–	–
	2013	2012
Weighted average remaining contracted life (years)	1	1
Weighted average fair value of awards granted (£)	3.89	3.01

The exercise price for the SMP is £nil (2012 £nil).

### Details of options/awards granted in the year

The fair value of equity-settled options/awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

ExSOP – Binomial model

PSP – Monte Carlo

RSP and SMP – Dividend valuation model

	2013	2012
Range of share price at date of grant (£)	3.89 – 4.40	3.01 – 3.29
Expected option/award life (years)	3 – 10	3 – 10
Volatility (%)	24 – 25	24
Risk free interest rate (%)	0.2 – 0.9	0.3 – 0.5

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 £4.07 (2012 £3.10).

## 30. Related party transactions

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 14) and pension schemes (note 23).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

Related party	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party		Management recharges	
	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m
Advanced Electronics Company Limited	1	–	50	19	–	–	–	–	–	–
CTA International SAS	1	1	–	–	1	2	–	–	–	–
Eurofighter Jagdflugzeug GmbH	1,048	1,324	–	–	30	136	92 <sup>1</sup>	161 <sup>1</sup>	–	–
FADEC International LLC	61	52	–	–	–	–	–	–	–	–
Gripen International KB	–	–	–	–	17	17	16 <sup>1</sup>	60 <sup>1</sup>	–	–
MBDA SAS	17	21	134	166	6	7	454 <sup>1</sup>	487 <sup>1</sup>	17 <sup>1</sup>	18 <sup>1</sup>
Panavia Aircraft GmbH	39	35	64	65	2	1	–	–	–	–
Saudi Development and Training Company Limited	1	–	15	–	–	–	1 <sup>1</sup>	–	–	–
	1,168	1,433	263	250	56	163	563	708	17	18

1. Also relates to disclosures under Financial Reporting Standard 8, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2013, £560m (2012 £705m) was owed by BAE Systems plc and £3m (2012 £3m) by other Group subsidiaries.

# Notes to the Group accounts – other information *continued*

## 30. Related party transactions (continued)

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 Annual remuneration report on pages 92 to 104. Total emoluments for directors and key management personnel charged to the consolidated income statement were:

	2013 £'000	2012 £'000
Short-term employee benefits	13,418	14,375
Post-employment benefits	1,676	2,163
Termination benefits	611	–
Share-based payments	4,163	4,029
	<b>19,868</b>	20,567

## 31. Contingent liabilities and commitments

### Customer dispute

Since 2009, BAE Systems, Inc. has been in dispute with a customer, AM General LLC. On 2 April 2013, the Superior Court in Gary, Indiana, USA, issued a ruling in favour of AM General's claim, denying a counterclaim from BAE Systems, Inc. and entering judgement against BAE Systems, Inc. which, including pre-judgement and estimated post-judgement interest amounts to \$290m (£175m). BAE Systems disagrees with the trial court's ruling and is currently appealing that decision. The process is expected to run into 2015 or later.

### Guarantees and performance bonds

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business and regards these as insurance contracts. 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 and shipyards 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:

	2013 £m	2012 £m
Payments due:		
Not later than one year	166	169
Later than one year and not later than five years	506	518
Later than five years	630	621
	<b>1,302</b>	1,308
Total of future minimum sublease income under non-cancellable subleases	<b>166</b>	188

### Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2013 £m	2012 £m
Property, plant and equipment	91	103
Intangible assets	18	2
	<b>109</b>	105

### 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 Controls Inc. (Held via BAE Systems, Inc.)	Designs, develops and manufactures electronic systems for commercial and military applications	100% common	US	US
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 Information Solutions Inc. (Held via BAE Systems Technology Solutions & Services Inc.)	Full-service information technology solution provider	100% common	US	US
BAE Systems Land & Armaments LP 1300 North 17th Street, Suite 1400, Arlington VA 22209, USA (Partners: BAE Systems Land & Armaments Inc. and BAE Systems Land & Armaments Holdings Inc.)	Manufactures and supports military vehicles	100%	US	US
BAE Systems Surface Ships Limited (Held via BAE Systems Surface Ships (Holdings) Limited)	Designs, develops and constructs surface ships in the naval arena, and provides fleet support services	100% ordinary	UK	England and Wales

The Company has taken advantage of the exemption under Section 410(2) of the Companies Act 2006 by providing information only in relation to subsidiary undertakings whose results or financial position, in the opinion of the directors, principally affected the financial statements. Accordingly, the subsidiaries listed in the table above are those that represent more than 5% of total Group sales or underlying EBITA<sup>1</sup>. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2013 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group accounts.

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

### 33. Events after the balance sheet date

In February 2014, the governments of the UK and Kingdom of Saudi Arabia agreed price escalation terms relating to the Typhoon aircraft under the Salam programme and these have been reflected in contractual arrangements between the UK government and BAE Systems. Accordingly, an adjustment has been made to sales and profit in 2013, reflecting the goods and services provided to the customer in both the current and prior years.

# Company balance sheet

as at 31 December

	Notes	2013 £m	2012 £m
<b>Fixed assets</b>			
Tangible assets		<b>10</b>	9
Investments in subsidiary undertakings	2	<b>8,057</b>	8,055
		<b>8,067</b>	8,064
<b>Current assets</b>			
Debtors due within one year	3	<b>3,662</b>	8,412
Debtors due after one year		<b>22</b>	9
Other financial assets due within one year	4	<b>126</b>	116
Other financial assets due after one year	4	<b>80</b>	100
Cash at bank and in hand		<b>1,732</b>	2,679
		<b>5,622</b>	11,316
<b>Liabilities falling due within one year</b>			
Loans and overdrafts	5	<b>(100)</b>	(21)
Creditors	6	<b>(8,223)</b>	(13,846)
Other financial liabilities	4	<b>(141)</b>	(113)
		<b>(8,464)</b>	(13,980)
<b>Net current liabilities</b>		<b>(2,842)</b>	(2,664)
<b>Total assets less current liabilities</b>		<b>5,225</b>	5,400
<b>Liabilities falling due after one year</b>			
Loans	5	<b>(1,159)</b>	(1,262)
Creditors	6	<b>(21)</b>	(30)
Other financial liabilities	4	<b>(86)</b>	(95)
		<b>(1,266)</b>	(1,387)
<b>Provisions for liabilities and charges</b>	7	<b>(52)</b>	(52)
<b>Net assets</b>		<b>3,907</b>	3,961
<b>Capital and reserves</b>			
Issued share capital	9	<b>89</b>	90
Share premium account	11	<b>1,249</b>	1,249
Statutory reserve	11	<b>202</b>	202
Other reserves	11	<b>88</b>	90
Profit and loss account	11	<b>2,279</b>	2,330
<b>Equity shareholders' funds</b>		<b>3,907</b>	3,961

Approved by the Board on 19 February 2014 and signed on its behalf by:

**I G King**  
Chief Executive

**P J Lynas**  
Group Finance Director



# Notes to the Company accounts

## 1. Accounting policies

### Basis of preparation

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss, and in accordance with applicable accounting standards in the UK (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(3) 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 11 to these accounts. The Company has no other recognised gains or losses in the current or preceding year and, therefore, no statement of recognised gains or losses is presented.

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.

### Cash flow statement

The Company is exempt under the terms of FRS 1, Cash Flow Statements, 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	5 years

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

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

### Leases

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

### Investments

The Company's investment in shares in Group companies is stated at cost less provision for impairment.

### Financial instruments

The policies disclosed in note 16 to the Group accounts for recognition, measurement and presentation of financial instruments are applied in the Company accounts.

### Tax

The charge for taxation is based on the profit for the year and takes account of taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Deferred tax is recognised on an undiscounted basis in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date where there is an obligation to pay more tax, or a right to pay less tax, in the future.

### Pensions and other post-retirement benefits

The Company contributes to Group pension schemes operated in the UK. Details of the principal schemes and the financial assumptions used are contained in the consolidated accounts of the Group. As permitted by FRS 17, Retirement Benefits, the schemes are accounted for as defined contribution schemes, as the employer cannot identify its share of the underlying assets and liabilities of the schemes. 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 funding deficits.

### Share-based payment compensation

The Company has granted equity-settled share options and Long-Term Incentive Plan (LTIP) arrangements to Group employees. Equity-settled share options and LTIP arrangements are measured at fair value at the date of grant. The fair value of awards granted to employees of the Company 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. The cost of awards to employees of subsidiary undertakings is accounted for as an additional investment in the employing subsidiary.

In accordance with Urgent Issues Task Force (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 and LTIP arrangements granted, except where the employee has agreed to settle the employer's national insurance liability as a condition of grant.

### Own shares held

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. Investments in subsidiary undertakings

	£m
<b>Cost</b>	
At 1 January 2013	8,116
Additions <sup>1</sup>	7
Disposals	(5)
<b>At 31 December 2013</b>	<b>8,118</b>
<b>Impairment provisions</b>	
<b>At 1 January 2013 and 31 December 2013</b>	<b>61</b>
<b>Net carrying value</b>	
<b>At 31 December 2013</b>	<b>8,057</b>
At 31 December 2012	8,055

1. Comprises the cost of share-based payments in respect of employees of subsidiary undertakings.

## 3. Debtors

	2013 £m	2012 £m
<b>Due within one year</b>		
Corporation tax recoverable	32	32
Amounts owed by subsidiary undertakings	3,585	8,340
Amounts owed by Group joint ventures	5	7
Prepayments and accrued income	24	25
Other debtors	16	8
	<b>3,662</b>	8,412

## 4. Other financial assets and liabilities

	2013 Assets £m	2013 Liabilities £m	2012 Assets £m	2012 Liabilities £m
<b>Due within one year</b>				
Cash flow hedges – foreign exchange contracts	–	(2)	1	(1)
Other foreign exchange/interest rate contracts	126	(139)	115	(112)
	<b>126</b>	<b>(141)</b>	116	(113)
<b>Due after one year</b>				
Cash flow hedges – foreign exchange contracts	–	(2)	–	(1)
Other foreign exchange/interest rate contracts	80	(84)	91	(94)
Debt-related derivative financial instruments – assets <sup>1</sup>	–	–	9	–
	<b>80</b>	<b>(86)</b>	100	(95)

1. The debt-related derivative financial instrument assets are presented as other financial assets. Debt-related derivative financial instrument liabilities are presented as a component of loans and overdrafts (see note 5).

Full disclosures relating to the Group's other financial assets and liabilities, and financial risk management strategies are given in notes 16, 27 and 28 to the Group accounts.

## 5. Loans and overdrafts

	2013 £m	2012 £m
<b>Due within one year</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	100	–
Overdrafts	–	21
	<b>100</b>	21
<b>Due after one year</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	–	100
US\$350m 3.5% bond, repayable 2016	211	214
US\$500m 4.75% bond, repayable 2021	301	307
£400m 4.125% bond, repayable 2022	397	397
US\$400m 5.8% bond, repayable 2041	238	243
Debt-related derivative financial instruments – liabilities	12	1
	<b>1,159</b>	1,262

## 6. Creditors

	2013 £m	2012 £m
<b>Due within one year</b>		
Amounts owed to subsidiary undertakings	7,338	12,802
Amounts owed to Group joint ventures	560	705
Accruals and deferred income	45	42
Other creditors	280	297
	<b>8,223</b>	13,846
<b>Due after one year</b>		
Other creditors	21	30
	<b>21</b>	30

## 7. Provisions for liabilities and charges

	Contracts and other £m
At 1 January 2013	52
Created	15
Utilised	(16)
Released	(2)
Discounting	3
<b>At 31 December 2013</b>	<b>52</b>

The Company holds provisions for contractual costs that it expects to incur over an extended period. These costs are based on past experience of similar items and represent management's best estimate of the likely outcome.

## 8. Contingent liabilities

### Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £1,661m (2012 £1,699m) which are included in the Group's borrowings have been guaranteed by the Company.

# Notes to the Company accounts *continued*

## 9. 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
<b>Issued and fully paid</b>					
At 1 January 2012 and 1 January 2013	3,588	90	1	1	90
Repurchased and cancelled	(52)	(1)	–	–	(1)
<b>At 31 December 2013</b>	<b>3,536</b>	<b>89</b>	<b>1</b>	<b>1</b>	<b>89</b>

### Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

### Share buyback

In 2013, 51,595,000 ordinary shares of 2.5p were repurchased under the buyback programme (2012 nil).

### Treasury shares

As at 31 December 2013, 327,644,952 (2012 336,813,996) ordinary shares of 2.5p each with an aggregate nominal value of £8,191,124 (2012 £8,420,350) were held in treasury. During 2013, 9,169,044 treasury shares were used to satisfy awards and options under the Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan (2012 14,942,858 in respect of the Share Incentive Plan, Share Matching Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan).

## 10. Employee share plans

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Annual remuneration report on pages 92 to 104.

	Executive Share Option Plan			
	2013		2012	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	9,601	3.30	5,539	3.64
Granted during the year	3,798	3.90	4,975	3.02
Exercised during the year	(1,056)	2.06	(200)	2.39
Expired during the year	(634)	3.92	(713)	4.29
Outstanding at the end of the year	11,709	3.57	9,601	3.30
Weighted average remaining contracted life (years)		7		6
Weighted average fair value of options granted (£)		0.59		0.38
Range of exercise price of outstanding options (£)		2.01 – 4.79		1.72 – 4.79
Expense recognised for the year (£m)		1		1

	Share Matching Plan		Performance Share Plan		Restricted Share Plan	
	2013 Number of shares '000	2012 Number of shares '000	2013 Number of shares '000	2012 Number of shares '000	2013 Number of shares '000	2012 Number of shares '000
Outstanding at the beginning of the year	5,690	5,732	10,519	11,910	101	9
Granted during the year	1,446	2,055	1,798	2,426	10	83
Exercised during the year	–	(958)	(500)	(805)	(53)	–
Expired during the year	(1,969)	(1,139)	(3,536)	(3,012)	(29)	9
Outstanding at the end of the year	5,167	5,690	8,281	10,519	29	101
Weighted average remaining contracted life (years)	1	1	5	5	5	6
Weighted average fair value of awards granted (£)	3.89	3.01	3.18	2.29	3.89	3.01
Expense recognised for the year (£m)	–	1	3	5	–	–

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2012 £nil).

Information on options/awards granted in the year can be found in note 29 to the Group accounts.



# Notes to the Company accounts *continued*

## 11. Reserves

	Share premium account £m	Statutory reserve £m	Other reserves £m	Profit and loss account £m
At 31 December 2012	1,249	202	90	2,330
Profit for the year	–	–	–	758
Dividends paid	–	–	–	(638)
Share-based payments	–	–	–	41
Purchase of own shares	–	–	1	(212)
Movements in hedging reserve	–	–	(3)	–
<b>At 31 December 2013</b>	<b>1,249</b>	<b>202</b>	<b>88</b>	<b>2,279</b>

### 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.

### Other reserves

Other reserves for the Company comprise: capital reserve £24m (2012 £24m); hedging reserve £4m debit (2012 £1m); capital redemption reserve £1m (2012 £nil) and non-distributable reserve arising from property disposals to other Group undertakings £67m (2012 £67m). 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 are transferred to the profit and loss account as distributable when the related properties are disposed of outside the Group, or written down following impairment.

### Profit and loss account

The Company's profit for the financial year was £758m (2012 £797m). The non-distributable portion of the profit and loss account is £196m (2012 £196m).

### Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

### BAE Systems ESOP Trust

The Group has an Employee Share Option Plan (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 2013.

At 31 December 2013, the ESOP held 1,451,631 (2012 2,633,198) ordinary shares of 2.5p each with a market value of £6m (2012 £9m). 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.

Dividend waivers were in operation for the dividends paid in June and December 2013 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants. A dividend waiver was also in operation for the dividends paid in June and December 2013 over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

## 12. Other information

### Employees

The total number of employees of the Company at 31 December 2013 was 831 (2012 801). Total staff costs, excluding charges for share-based payments, were £102m (2012 £129m).

### Directors' emoluments

Under Schedule 5 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (Schedule 5), total directors' emoluments, excluding Company pension contributions, were £6,289,295 (2012 £6,542,000); these amounts are calculated on a different basis to emoluments in the Annual remuneration report which are calculated under Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (Schedule 8 (2013)). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company. Under Schedule 5, the aggregate gains made by directors from the exercise of share options in 2013 as at the date of exercise was £1,909,962 (2012 £370,881) and the net aggregate value of assets received by directors in 2013 from Long-Term Incentive Plans as calculated at the date of vesting was £129,722 (2012 £869,116); these amounts are calculated on a different basis from the valuation of share plan benefits under Schedule 8 (2013) in the Annual remuneration report.

### Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,621,000 (2012 £1,570,000).

### Related party transactions

Details of related party transactions are detailed in note 30 to the Group accounts.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

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

## Opinions and conclusions arising from our audit

### 1 Our opinion on the financial statements is unmodified

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2013 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Group and parent company balance sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity and related notes. 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

### 2 Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements the risks of material misstatement that had the greatest effect on our audit were as follows:

Risk

The procedures to address these audit risks included, amongst others, those listed below

#### Recognition of revenues and profits on long-term contracts

Refer to page 75 (Audit Committee report) and page 130 (accounting policy and financial disclosures)

A significant proportion of the Group's revenues and profits are derived from long-term contracts.

These contracts include complex technical and commercial risks and often specify performance milestones to be achieved throughout the contract period, which can last many years, resulting in estimates and assumptions being made to:

- forecast the margin on each contract after making appropriate allowances for technical and commercial risks related to performance milestones yet to be achieved; and
- assess the proportion of revenue to recognise, in particular with regards to the value of claims for contract variations.

The risk of misstatement is that the accounting for the Group's significant contracts does not accurately reflect the status of the relevant contract.

The directors have detailed procedures and processes, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial aspects of the Group's long-term contracts. The LCM process includes the regular preparation of a Contract Status Report (CSR) which includes key accounting information for the relevant contract.

We considered the design and tested the effective operation of key LCM controls. For significant contracts, determined on the basis of technical and commercial complexity and profitability of the contract, we also:

- obtained an understanding of the status of the contract through discussions with contract project teams and directors at a Group and operating business unit level, attendance at project teams' contract review meetings, and examining externally available evidence, such as customer correspondence; and
- challenged the key estimates and assumptions applied in determining financial status of these contracts by:
  - corroborating the consistency of changes in the updated contract financial information summarised in the year-end CSRs to other financial information received;
  - considering how key uncertainties are reflected in the contracts' status taking into account externally available information;
  - assessing whether allowances for risks and uncertainties are consistent with past experience considering the maturity of the contracts and the extent of technical or commercial risk identified; and
  - using our cumulative knowledge of contract issues to assess the appropriateness of the contract positions reflected in the financial statements at the year end.

We performed the above procedures, amongst others, in respect of the Group's significant contracts which included, but are not limited to:

- Saudi Typhoon aircraft;
- Radford Army Ammunition Plant; and
- Queen Elizabeth Class aircraft carriers.

We also considered the adequacy of the Group's segmental and operating cost disclosures in respect of changes in the status of contracts which had a material impact on the Group's financial performance for the year.

# Independent auditor’s report to the members of BAE Systems plc

continued

Risk	The procedures to address these audit risks included, amongst others, those listed below
<b>Carrying value of US goodwill (£7.5bn)</b> Refer to page 74 (Audit Committee report) and page 146 (accounting policy and financial disclosures) An impairment charge of £865m was recognised against the US cash-generating units in 2013.  The uncertainty over future US defence spending increases the risk that the goodwill allocated to the Group’s US cash-generating units will not be recoverable.  Due to the inherent uncertainty involved in forecasting and discounting future cash flows, which are the basis of the assessment of recoverability, this is one of the key judgemental areas that our audit is concentrated on.	 The directors’ annual goodwill impairment testing is based on the Group’s five-year Integrated Business Plan.  We considered the Group’s budgeting procedures upon which the forecasts are based and the principles and integrity of the Group’s discounted cash flow model.  We compared the Group’s assumptions, where possible, to externally derived data as well as our own assessments in relation to key inputs, such as projected economic growth, inflation and likely customer spending priorities. We used our own valuation specialists in also assessing the discount rates used. We performed breakeven analysis on the key assumptions and, as a sense check, compared the sum of discounted cash flows to the Group’s market capitalisation to assess the reasonableness of those cash flows.  We also assessed whether the Group’s disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflected the risks inherent in the valuation of goodwill.
<b>Retirement benefit obligations (£3.5bn)</b> Refer to page 74 (Audit Committee report) and page 162 (accounting policy and financial disclosures) As presented in note 23 of the financial statements, the Group’s share of the net deficit was £3.5bn after allocating £1.0bn to equity accounted investments and other participating employers.  Small changes in assumptions and estimates used to value the Group’s retirement benefit obligation, including those supporting the proportion allocated to equity accounted investments and other participating employers, have a significant impact on the Group’s share of the retirement benefit obligation.	 We considered whether the methodology used by the directors, to allocate a proportion of the Group’s retirement benefit obligation to the equity accounted investments and other participating employers, was appropriate in estimating such allocation with reference to agreements between the Group and the equity accounted investments and participating employers.  We challenged the key assumptions supporting the Group’s retirement benefit obligations valuation, with input from our own actuarial specialists. This included a comparison of the discount, inflation and life expectancy assumptions used against externally derived data.  We also considered the adequacy of the Group’s disclosures in respect of the sensitivity of the deficit to changes in these key assumptions.
<b>Tax accruals</b> Accruals for tax contingencies require the directors to make judgements and estimates in relation to tax risks. This is one of the key judgemental areas that our audit is concentrated on due to the Group operating in a number of tax jurisdictions, the complexities of international tax legislation and the time taken for tax matters to be agreed with the tax authorities.	 We used our own international and local tax specialists to assess the Group’s tax positions, its correspondence with the relevant tax authorities and its external tax advisers and to analyse and challenge the assumptions used to determine tax accruals based on our knowledge and experience of the application of the international and local legislation by the relevant authorities and courts. We have also considered the adequacy of the Group’s disclosures in respect of tax and uncertain tax positions.

### 3 Our application of materiality and an overview of the scope of our audit

In establishing the overall audit strategy, and performing the audit, materiality for the Group financial statements as a whole was set at £100m. This has been determined with reference to a benchmark of Group profit before taxation which we believe to be one of the principal considerations for members of the Company in assessing financial performance of the Group. The same benchmark was used in the prior year.

Materiality represents 8% of Group profit before taxation excluding the impairment charge for the year as disclosed on the face of the Consolidated Income Statement.

We agreed with the Audit Committee to report to it all corrected and uncorrected misstatements we identified through our audit with a value in excess of £5m for income statement items in addition to other audit misstatements we believe warranted reporting on qualitative grounds.

We considered the individual financial significance and level of significant contract judgements at each business unit (components) and the requirement to prepare local audited statutory financial statements in scoping the procedures for our Group audit.

As a result, audits for Group reporting purposes were performed at 12 of BAE Systems' components based in the UK, the US, the Kingdom of Saudi Arabia and Australia. These audits covered 74% of Group revenue, 82% of profits and losses before tax, and 84% of Group total assets. Three of these component audits were performed by the Group audit team with the remainder performed by component audit teams. Specified audit procedures were also performed at an additional five components covering an additional 13% of Group revenue, 8% of profits and losses before tax, and 5% of Group total assets.

The audit procedures at each of the components for Group reporting purposes were all performed to materiality levels set by, or agreed with, the Group audit team. These materiality levels were set individually for each component and ranged from £6m to £50m.

Detailed instructions were sent to all component auditors. These instructions included the significant areas that should be covered by these component auditors (which included the relevant risks of material misstatement detailed above) and set out the information required to be reported back to the Group audit team. The Group audit team visited the more significant components in each of the following countries: the UK, the US, the Kingdom of Saudi Arabia and Australia. Telephone meetings were also held with the component auditors of these components and the majority of the other components that were not physically visited.

### 4 Our opinion on other matters prescribed by the Companies Act 2006 is unmodified

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 Strategic Report and Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

### 5 We have nothing to report in respect of the matters on which we are required to report by exception

Under International Standards on Auditing (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the

Annual Report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy; or
- the Audit Committee report does not appropriately address matters communicated by us to the Audit Committee.

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 70, in relation to going concern; and
- the part of the Governance section relating to the Company's compliance with the nine provisions of the 2010 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

### Scope of report and responsibilities

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at [www.frc.org.uk/auditscopeukprivate](http://www.frc.org.uk/auditscopeukprivate). This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at [www.kpmg.com/uk/auditscopeukco2013a](http://www.kpmg.com/uk/auditscopeukco2013a), which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

**Ian Starkey (Senior Statutory Auditor)**  
**For and on behalf of KPMG Audit Plc, Statutory Auditor**  
 Chartered Accountants  
 15 Canada Square  
 London  
 E14 5GL

19 February 2014

# Five-year summary

## Income statement for the year ended 31 December

	2013 £m	Restated <sup>1</sup> 2012 £m	2011 £m	2010 £m	2009 £m
<b>Continuing operations<sup>2</sup></b>					
<b>Sales including Group's share of equity accounted investments</b>					
Electronic Systems	2,466	2,507	2,645	2,969	2,899
Cyber & Intelligence	1,243	1,402	1,399	1,201	1,302
Platforms & Services (US)	4,196	4,539	5,305	7,671	8,414
Platforms & Services (UK)	6,890	5,717	6,258	6,529	6,153
Platforms & Services (International)	4,063	4,071	3,794	4,325	3,658
HQ	306	267	233	209	172
Intra-group sales	(984)	(598)	(480)	(629)	(756)
	<b>18,180</b>	17,905	19,154	22,275	21,842
<b>Underlying EBITA<sup>3</sup></b>					
Electronic Systems	346	356	386	455	348
Cyber & Intelligence	115	124	136	108	107
Platforms & Services (US)	265	394	478	728	747
Platforms & Services (UK)	879	695	658	522	661
Platforms & Services (International)	429	417	449	449	402
HQ	(109)	(124)	(82)	(83)	(114)
	<b>1,925</b>	1,862	2,025	2,179	2,151
Profit/(loss) on disposal of businesses	6	103	(29)	1	68
Pension curtailment gains	–	–	–	2	261
Regulatory penalties	–	–	(49)	(18)	(278)
<b>EBITA</b>	<b>1,931</b>	1,965	1,947	2,164	2,202
Amortisation and impairment of intangible assets	(1,076)	(312)	(348)	(517)	(1,259)
Finance costs including share of equity accounted investments	(392)	(410)	(106)	(194)	(694)
<b>Profit before taxation</b>	<b>463</b>	1,243	1,493	1,453	249
Taxation expense including share of equity accounted investments	(287)	(284)	(233)	(462)	(344)
<b>Profit/(loss) for the year – continuing operations</b>	<b>176</b>	959	1,260	991	(95)
(Loss)/profit for the year – discontinued operations	–	–	(4)	90	50
<b>Profit/(loss) for the year</b>	<b>176</b>	959	1,256	1,081	(45)

## Balance sheet as at 31 December

	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Intangible assets	9,735	10,928	11,465	11,216	11,306
Property, plant and equipment, and investment property	2,071	2,407	2,626	2,848	2,663
Non-current investments	286	270	788	798	852
Inventories	680	655	716	644	887
Assets held in Trust	–	–	403	261	227
Payables (excluding cash received on customers' account) less receivables	(4,718)	(6,419)	(5,386)	(6,159)	(6,918)
Other financial assets and liabilities	(23)	(50)	(219)	(10)	(45)
Retirement benefit obligations	(3,665)	(4,607)	(4,673)	(3,456)	(4,679)
Provisions	(794)	(746)	(954)	(1,077)	(929)
Net tax	405	951	975	580	896
Net (debt)/cash (as defined by the Group)	(699)	387	(1,439)	(242)	403
Assets/(liabilities) held for sale	140	(2)	(3)	–	–
Non-controlling interests	(37)	(54)	(59)	(71)	(72)
<b>Total equity attributable to equity holders of the parent</b>	<b>3,381</b>	3,720	4,240	5,332	4,591



**Movement in net (debt)/cash (as defined by the Group) for the year ended 31 December**

	<b>2013</b>	2012	2011	2010	2009
	<b>£m</b>	£m	£m	£m	£m
Cash inflow from operating activities	<b>205</b>	2,458	951	1,535	2,232
Add back: Amounts already deducted from net (debt)/cash (as defined by the Group) <sup>4</sup>	<b>–</b>	458	–	–	–
	<b>205</b>	2,916	951	1,535	2,232
Net capital expenditure <sup>5</sup>	<b>(153)</b>	(293)	(268)	(364)	(489)
Dividends received from equity accounted investments	<b>95</b>	94	88	71	77
Assets contributed to Trust	<b>–</b>	(25)	(137)	(25)	(225)
Cash held for charitable contribution to Tanzania	<b>–</b>	–	–	(30)	–
Operating business cash flow	<b>147</b>	2,692	634	1,187	1,595
Acquisitions and disposals	<b>4</b>	96	(256)	(88)	(254)
Interest	<b>(166)</b>	(147)	(176)	(173)	(186)
Tax and dividends	<b>(787)</b>	(746)	(885)	(958)	(889)
Purchase of equity shares	<b>(212)</b>	(16)	(509)	(520)	(20)
Foreign exchange adjustments	<b>3</b>	92	(20)	(20)	262
Other movements <sup>6</sup>	<b>(76)</b>	(146)	2	(80)	(132)
Net (decrease)/increase in net funds	<b>(1,087)</b>	1,825	(1,210)	(652)	376
Movement in cash received on customers' account	<b>1</b>	1	13	7	(12)
Movement in net (debt)/cash (as defined by the Group)	<b>(1,086)</b>	1,826	(1,197)	(645)	364
Opening net cash/(debt) (as defined by the Group)	<b>387</b>	(1,439)	(242)	403	39
<b>Closing net (debt)/cash (as defined by the Group)</b>	<b>(699)</b>	387	(1,439)	(242)	403

**Other information**

	<b>2013</b>	Restated <sup>1</sup> 2012	2011	2010	2009
<b>Continuing operations<sup>2</sup></b>					
Basic earnings/(loss) per share – total (pence)	<b>5.2</b>	29.3	37.0	27.9	(3.3)
Basic earnings per share – underlying <sup>7</sup> (pence)	<b>42.0</b>	38.7	45.6	39.8	39.1
Order backlog <sup>8</sup> including the Group's share of equity accounted investments (£bn)	<b>42.7</b>	42.5	39.1	n/a	n/a
<b>Including discontinued operations</b>					
Dividend per ordinary share (pence)	<b>20.1</b>	19.5	18.8	17.5	16.0
Number of employees, excluding share of employees of equity accounted investments, at year end	<b>78,000</b>	81,000	87,000	92,000	98,000
Capital expenditure including leased assets (£m)	<b>273</b>	404	381	437	522

1 On adoption of the revised IAS 19, Employee Benefits.

2 The Regional Aircraft line of business is presented as a continuing operation in 2013 and 2012. For 2009 to 2011, the Regional Aircraft line of business and Saab AB are presented as discontinued operations.

3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. For 2013 and 2012, non-recurring items comprises profit on disposal of businesses. For 2009 to 2011, non-recurring items are profit/loss on disposal of businesses, pension curtailment gains and regulatory penalties.

4 Comprises the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net (debt)/cash.

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

6 Includes cash flows from matured derivative financial instruments, cash collateral and other non-cash movements.

7 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items. For 2013 and 2012, non-recurring items comprises profit on disposal of businesses. For 2009 to 2011, non-recurring items are profit/loss on disposal of businesses, pension curtailment gains and regulatory penalties.

8 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.

# Shareholder information

## Registered office

6 Carlton Gardens  
London  
SW1Y 5AD  
United Kingdom

Telephone: +44 (0)1252 373232

Company website: [www.baesystems.com](http://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

If you have any queries regarding your shareholding or need to notify any changes to your personal details, please contact Equiniti.

Equiniti's website (<https://help.shareview.co.uk>) includes a comprehensive set of answers to many frequently asked questions relating to managing a shareholding. If you cannot find the answer to your question, there is an online e-mail form, which will help to ensure your question is directed to the most appropriate team for a response. Alternatively, you can call the BAE Systems Helpline on 0871 384 2044\* or, from outside the UK, +44 121 415 7058.

\* Calls to the above number are charged at 8p per minute plus network extras. Lines are open from 8.30am to 5.30pm Monday to Friday.

## Shareview – online access to your shareholding

Shareview is a free portfolio service offered by Equiniti to investors which gives shareholders online access to more information on their investments, including balance movements, indicative share prices and information on recent payments. It can also be used to sign up to receive all shareholder communications electronically and, once registered, arrange for dividends to be mandated or update your address. To take advantage of Shareview, register online at [www.shareview.co.uk](http://www.shareview.co.uk). Click on 'Register' and follow the four easy steps.

Details of software and equipment requirements are given on the website.

## Share register initiatives and shareholder donations

As with any listed company with a large share register, over time we lose touch with some of our shareholders. During 2013, we asked ProSearch, a specialist tracing agency, to conduct an Asset Reunification Programme, to try and trace many of those shareholders for whom we did not appear to hold an up-to-date address, in order to reunite them with their shares and unpaid dividends. These shareholders were given the option of claiming their full entitlement or donating to our nominated charity, Blind Veterans UK. During 2013, over 4,700 shareholders were traced, more than 630,000 shares reactivated and £11,800 donated to Blind Veterans UK. The programme will continue into 2014.

In September, we launched a Share Dealing Service to those shareholders who held 1,000 or fewer shares, which proved very successful. Shareholders were able to purchase shares, sell their entire shareholding or donate their shareholding to charity. In total, over £6,300 was donated to Blind Veterans UK, via ShareGift.

## ShareGift

ShareGift, the share donation charity (registered charity number 1052686), accepts donations of small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at [www.sharegift.org](http://www.sharegift.org), by telephone on 020 7930 3737 or by e-mail: [help@sharegift.org](mailto:help@sharegift.org)

## Dividend mandate

If you have a UK bank or building society account and would like to apply a bank mandate to your shareholding, a mandate form can be obtained from our website or by contacting Equiniti. Alternatively, bank details can be submitted:

- in writing to Equiniti;
- electronically via Shareview; or
- if the shareholding is held in a sole name, Equiniti can take instructions over the telephone.

Do you have an overseas bank account? Instead of waiting for a sterling cheque to arrive by post, why not take advantage of Equiniti's overseas payments service? Equiniti can arrange payment for over 90 countries worldwide. It normally costs less than paying in a sterling cheque and only takes a few days for the money to arrive into the account after the dividend payment date. For more information on the terms and conditions of this service, and to obtain the appropriate mandate form, visit the Shareview website ([www.shareview.com/overseas](http://www.shareview.com/overseas)) or contact Equiniti direct.

## Electronic shareholder communications

An increasing number of shareholders receive communications from the Company using e-mail and web-based communications.

The use of electronic communications, rather than printed paper documents, helps us reduce the environmental impact of our activities and assists us in managing our costs.

We regularly consult with shareholders to check how they wish to receive information from us. Shareholders may receive electronic communications in one of two ways:

- Via e-mail – This option is available through Shareview. Shareholders receive an e-mail notification when a new document is made available, which contains a link to the document.
- Via our website – Shareholders receive a notification by post when a new document is made available.

A shareholder is taken to have agreed to website communications if a response to a consultation has not been received. Any document or information required to be sent to shareholders is made available on the Company's website and a notification of availability is sent. Shareholders who receive such a notification are entitled to request a hard copy of the document at any time and may also change the way they receive communications at any time by contacting Equiniti.

Notwithstanding any election, the Company may, at its sole and absolute discretion, send any notification or information to shareholders in hard copy form.

## Dividend reinvestment plan (DRIP)

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.

Shareholders who currently have a DRIP mandate in place should note that the Terms and Conditions have recently been changed. A full copy of the Terms and Conditions and an application form can be obtained by contacting Equiniti, or by visiting their website: [www.shareview.co.uk/Products/Pages/applyforadrip.aspx](http://www.shareview.co.uk/Products/Pages/applyforadrip.aspx)

## Share price information

The middle market price of the Company's ordinary shares on 31 December 2013 was 435.0p and the range during the year was 327.4p to 468.0p.

**American Depositary Receipts**

BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depositary. If you should have any queries, please contact:

JPMorgan Chase & Co  
PO Box 64504  
St Paul  
MN 55164-0504 USA

Email: [jpmorgan.adr@wellsfargo.com](mailto:jpmorgan.adr@wellsfargo.com)  
Telephone number for general queries: (800) 990 1135  
Telephone number from outside the US: +1 651 453 2128

**Beware of share fraud**

Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment. While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

5,000 people contact the Financial Conduct Authority (FCA) about share fraud each year, with victims losing an average of £20,000.

**How to avoid share fraud**

1. Keep in mind that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services Register from [www.fca.org.uk](http://www.fca.org.uk) to see if the person and firm contacting you is authorised by the FCA.
4. Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
5. Use the firm's contact details listed on the Register if you want to call it back.
6. Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
7. Search the list of unauthorised firms to avoid at [www.fca.org.uk/scams](http://www.fca.org.uk/scams)
8. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme.
9. Think about getting independent financial and professional advice before you hand over any money.
10. **Remember:** if it sounds too good to be true, it probably is!

**Report a scam**

If you are approached by fraudsters please tell the FCA using the share fraud reporting form at [www.fca.org.uk/scams](http://www.fca.org.uk/scams), where you can find out more about investment scams.

You can also call the FCA Consumer Helpline on **0800 111 6768**.

If you have already paid money to share fraudsters you should contact Action Fraud on **0300 123 2040**.

**Financial calendar**

Financial year end	31 December
Annual General Meeting	7 May 2014
2013 final ordinary dividend payable	2 June 2014
2014 half-yearly results announcement	31 July 2014
2014 interim ordinary dividend payable	1 December 2014
2014 full year results – preliminary announcement	February 2015
– report and accounts	March 2015
2014 final ordinary dividend payable	June 2015

**Analysis of share register at 31 December 2013**

	Ordinary shares of 2.5p			
	Accounts		Shares	
	Number '000	%	Number <sup>1</sup> million	%
<b>By category of shareholder</b>				
Individuals	88.3	92.3	90.1	2.6
Nominee companies	2.2	2.3	2,969.3	83.9
Banks	–	–	7.0	0.2
Other	5.2	5.4	470.8	13.3
	<b>95.7</b>	<b>100.0</b>	<b>3,537.2</b>	<b>100.0</b>
<b>By size of holding</b>				
1 – 99	19.4	20.3	0.9	–
100 – 499	27.3	28.5	7.3	0.2
500 – 999	18.3	19.1	13.1	0.4
1,000 – 9,999	28.6	29.9	69.0	2.0
10,000 – 99,999	1.3	1.4	33.5	0.9
100,000 – 999,999	0.5	0.5	176.6	5.0
1,000,000 and over	0.3	0.3	3,236.8	91.5
	<b>95.7</b>	<b>100.0</b>	<b>3,537.2</b>	<b>100.0</b>

1 Includes 960,000 shares repurchased under the share buyback programme between 24 and 31 December 2013, the cancellation of which had not been completed at 31 December 2013.

# Glossary

<b>AGM</b>	Annual General Meeting.
<b>ATTAC</b>	Availability Transformation Tornado Aircraft Contract.
<b>CPI</b>	Consumer Prices Index.
<b>CV90</b>	Combat Vehicle 90.
<b>DEWS</b>	Digital Electronic Warfare System.
<b>EADS</b>	European Aeronautic Defence and Space Company.
<b>EAP</b>	Employee Assistance Programme.
<b>EBITA</b>	Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
<b>EC</b>	Executive Committee.
<b>ECP</b>	Engineering Change Proposal.
<b>EPS</b>	Earnings per share.
<b>ESOP</b>	Employee Share Option Plan.
<b>EU</b>	European Union.
<b>EV</b>	Expected Value.
<b>ExPS</b>	Executive Pension Scheme.
<b>ExSOP</b>	Executive Share Option Plan.
<b>FADEC</b>	Full Authority Digital Engine Controls.
<b>FCO</b>	Foreign & Commonwealth Office.
<b>FIRST</b>	Foundation for Inspiration and Recognition of Science and Technology.
<b>FMS</b>	Foreign Military Sales.
<b>FPE</b>	Final Pensionable Earnings.
<b>FPP</b>	Final Pensionable Pay.
<b>FRS</b>	Financial Reporting Standard.
<b>GAAP</b>	Generally Accepted Accounting Practice.
<b>GAO</b>	US Government Accountability Office.
<b>GEOINT</b>	Geospatial Intelligence.
<b>IAS</b>	International Accounting Standard.
<b>IBP</b>	Integrated Business Plan.
<b>IEMA</b>	Institute of Environmental Management and Assessment.
<b>IFBEC</b>	International Forum on Business Ethical Conduct.
<b>IFRS</b>	International Financial Reporting Standard.
<b>ISR</b>	Intelligence, Surveillance and Reconnaissance.
<b>JETS</b>	Joint Effects Targeting System.

<b>JLTV</b>	Joint Light Tactical Vehicle.
<b>KPI</b>	Key Performance Indicator.
<b>LCM</b>	Lifecycle Management.
<b>LHD</b>	Landing Helicopter Dock.
<b>LRASM</b>	Long-Range Anti-Ship Missile.
<b>LRIP</b>	Low-Rate Initial Production.
<b>LTA</b>	Lifetime Allowance.
<b>LTIP</b>	Long-Term Incentive Plan.
<b>M777</b>	A lightweight 155mm field howitzer.
<b>M&amp;A</b>	Mergers and Acquisitions.
<b>MoD</b>	Ministry of Defence.
<b>NED</b>	Non-executive director.
<b>OAS</b>	Operational Assurance Statement.
<b>OCF</b>	Operating Cash Flow.
<b>OPV</b>	Offshore Patrol Vessel.
<b>PIM</b>	Paladin Integrated Management.
<b>PSP</b>	Performance Share Plan.
<b>QBR</b>	Quarterly Business Review.
<b>R&amp;D</b>	Research and Development.
<b>RAF</b>	Royal Air Force.
<b>RCF</b>	Revolving Credit Facility.
<b>RPI</b>	Retail Prices Index.
<b>RSAF</b>	Royal Saudi Air Force.
<b>RSNF</b>	Royal Saudi Naval Forces.
<b>RSP</b>	Restricted Share Plan.
<b>SBDGP</b>	Saudi British Defence Co-operation Programme.
<b>SHE</b>	Safety, Health and Environment.
<b>SIGINT</b>	Signal Intelligence.
<b>SMM</b>	Safety Maturity Matrix.
<b>SMP</b>	Share Matching Plan.
<b>ToBA</b>	Terms of Business Agreement.
<b>TPL</b>	Total Performance Leadership.
<b>TRMC</b>	Treasury Review Management Committee.
<b>TSR</b>	Total Shareholder Return.
<b>UAE</b>	United Arab Emirates.
<b>UITF</b>	Urgent Issues Task Force.
<b>WARN</b>	Worker Adjustment and Retraining Notification.

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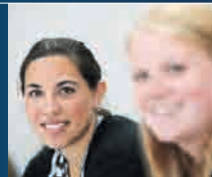
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BAE Systems plc  
6 Carlton Gardens  
London SW1Y 5AD  
United Kingdom  
Telephone: +44 (0) 1252 373232  
[www.baesystems.com](http://www.baesystems.com)

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