



Gaining momentum

BAE SYSTEMS

REAL UNDERSTANDING. REAL ADVANTAGE.

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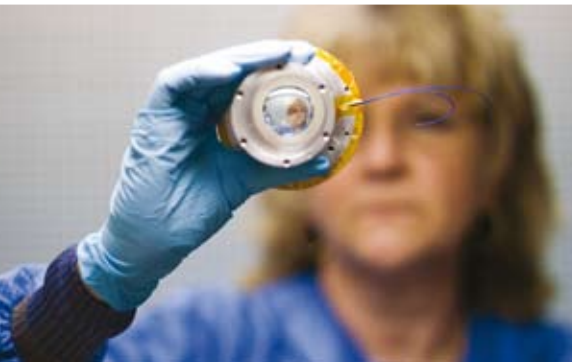
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Welcome to BAE Systems' 2007 Corporate Responsibility Report

This report provides an overview of our approach to Corporate Responsibility (CR). It summarises the progress we made during 2007 and highlights the areas where we want to do more.

Our objectives in this report are to:

- increase the amount of information available in the public domain on how we and the defence industry operate
- present and discuss our CR strategy and priorities.

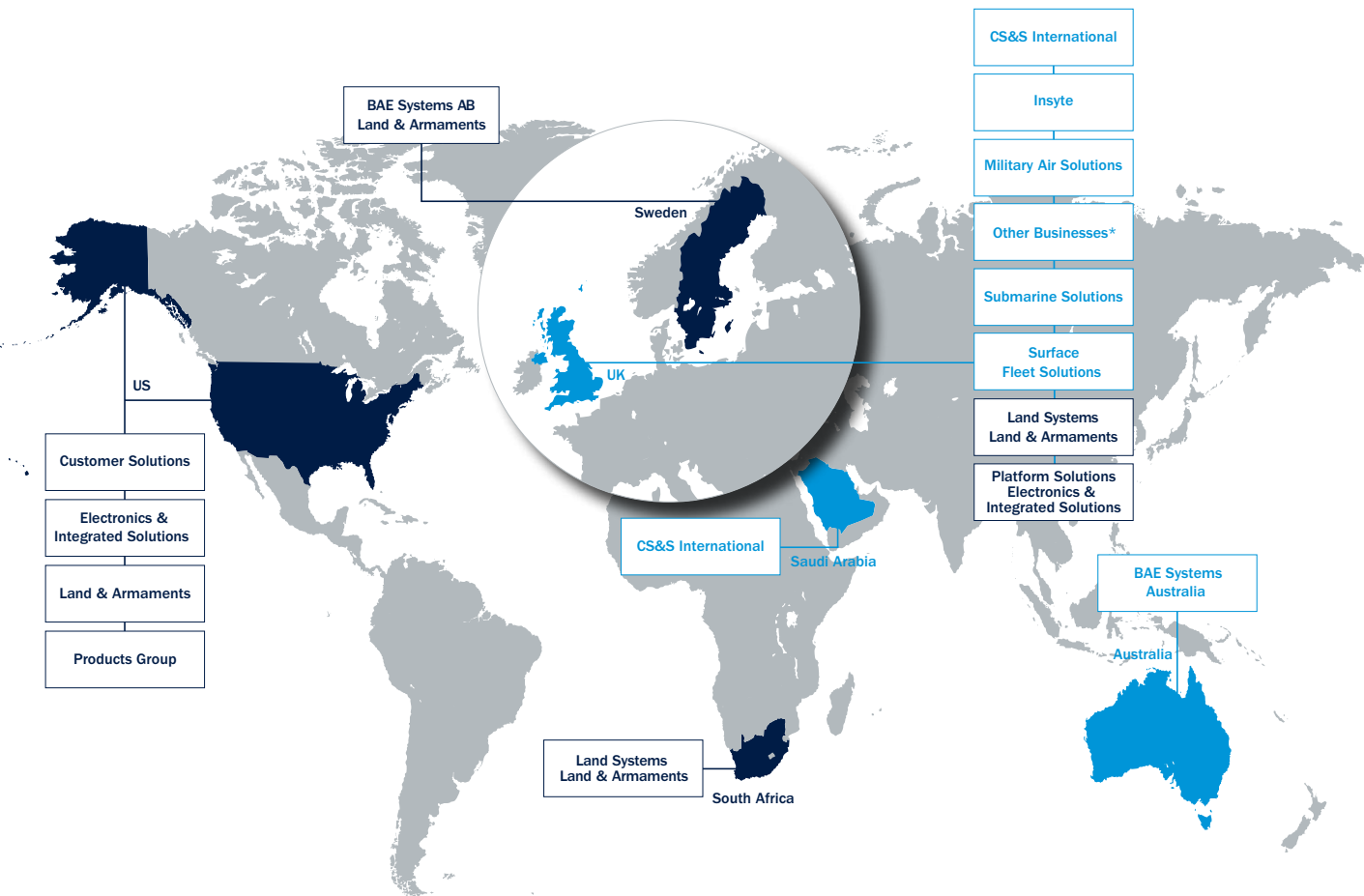
We have sought views from experienced CR practitioners on how we can achieve leadership performance on our CR priorities. This panel reviewed our strategy and a draft copy of key sections of this report. A summary of its comments is included on page 6.

This report focuses on the issues we have identified as CR priorities for our business – ethics and safety. Information on other aspects of CR at BAE Systems is included in the data file at the back of this document.

Our global Comp

Our global business is based around our Home Markets in Australia, Saudi Arabia, South Africa, Sweden, the UK and the US. These are markets identified as having a significant and sustained commitment to defence, and where we already have a good position in their defence industrial bases along with strong customer relationships. We intend to invest and grow in these markets.

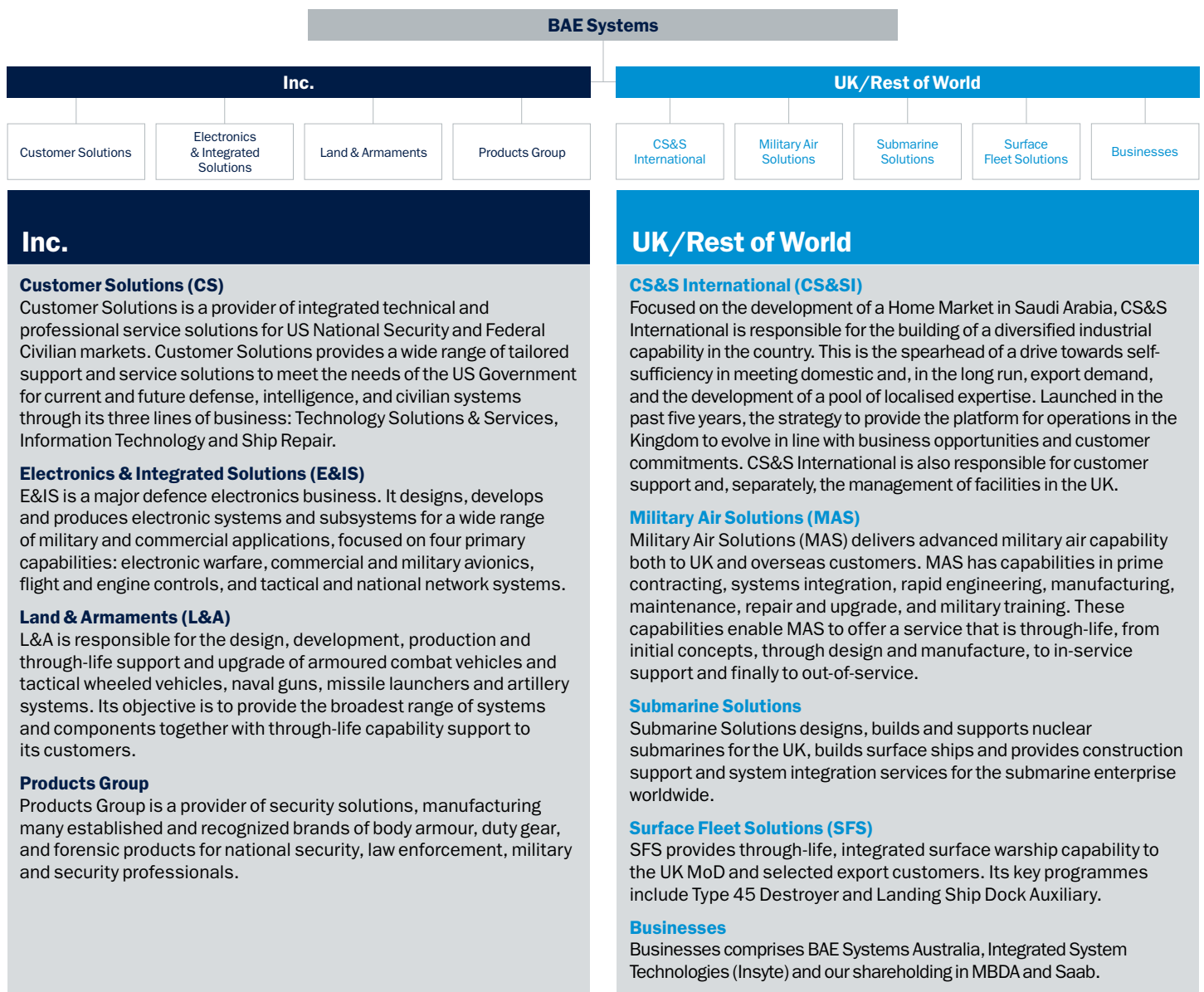
Our existing Home Markets



* Other Businesses comprises the Regional Aircraft asset management and support activities, and UK Shared Services activity.

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Our operating structure



A proactive agenda

Message from the CEO

We are determined that our Company should be recognised as a leader in responsible business.



At the beginning of 2007 and in last year's CR Report, we committed to developing a proactive CR agenda aligned with our Company Strategy. In May 2007, I and my Executive Committee colleagues participated in a workshop where we debated the implications of our Company Strategy and the direction and focus required of our CR agenda. While our CR performance places us amongst the leading companies in the defence sector, we recognise that our aspiration to be a truly global company means we must look across all sectors and benchmark ourselves against the best there is. Accordingly we confirmed ethics and safety as our priority areas and committed to attain a performance level that is on a par with leading companies. We have set stretching targets to drive the performance improvements (see page 5) and my colleagues and I have accepted that delivery on these targets should form a specific part of how our performance and remuneration are assessed this year.

During 2007, the Board appointed Lord Woolf, the former Lord Chief Justice of England and Wales, to establish an expert independent committee to study and report on our ethics policies and processes and make recommendations aimed at achieving a leadership position in ethical business practice amongst corporate industry peers. The report will be published later this year and the Board has undertaken to act on all such recommendations of the Committee.


Throughout 2007, we continued to improve our safety performance (see page 18) and some of our businesses, in particular Surface Fleet Solutions, made significant progress in safety performance improvements. We have a zero tolerance approach to an unsafe workplace and unsafe working practices and want all our businesses to operate at the highest levels of

good safety management. During 2007, we conducted a benchmarking exercise to establish the leading level of performance and have developed a four-year plan for improving our safety performance. Initial focus areas include: visible senior leadership, establishing specific targets for improvement and linking safety performance to senior management bonuses. These have been incorporated into our 2008 leadership objectives.

While we have demonstrated real improvements, I and the rest of the Company were deeply saddened by two separate incidents in the past 12 months, which led to the tragic loss of two of our employees. We are fully supporting the inquiries into these incidents.

We value external perspectives in helping determine our approach to CR issues and improve our performance. This year we invited a panel of external CR experts to give their views on our strategy and direction. Their input will help us continue to progress our strategy and achieve a level of performance appropriate to a leading global company.

During my time at BAE Systems, CR has become increasingly embedded into our Company Strategy and I believe this is creating real benefits for our business and our stakeholders. I leave the Company this year knowing that CR will remain an integral part of our high-performance culture and will help BAE Systems in our aim to achieve sustainable and profitable growth well into the future.


Mike Turner
CEO

Our role and responsibilities



BAE Systems' Strategy is to deliver sustainable growth in shareholder value by being the premier global defence and aerospace company.

Why we exist

The first responsibility of any government is to ensure national security and to protect its citizens. This provides the stability necessary for sustainable economic and social development.

The role of the defence industry is to support governments in providing national security. Human nature creates conflict, not the defence industry. It is naïve to think that there would be no more conflict if the defence industry did not exist.

We all live with the threat of terrorism, violence and war. The defence industry has an important role to play in helping to tackle these issues. At the same time, we need to address the responsibilities associated with our industry and the role and potential use of our products. We aim to make sure people understand the difference between a responsible defence company and the illegal arms trade.

What we stand for

We are proud to be part of the defence industry and see our role as providing support for national security and protection for sovereign governments, their citizens and their forces, while delivering value to our investors. We recognise the serious nature of our business and know that we must operate responsibly in everything that we do.

We are an ethical company and aim to demonstrate the highest standards of integrity and responsible management. We do not tolerate unethical behaviour or illegal conduct. Underpinning this are our Company values:

High performance – we will set targets to be the best, continually challenging and improving the way we do things, both as individuals and as members of our teams

Customers – our priority to all our customers, both internal and external, is to understand their needs and expectations and deliver on our commitments

People – all our people will follow our principles of Accountability, Honesty, Integrity, Openness and Respect and will be encouraged to realise their full potential as valued members of our team

Partnering – we will strive to be the partner of choice, respected by everyone for our co-operation, integrity and openness

Innovation and technology – we will encourage the development and implementation of new ideas, new technologies and new ways of working, to secure sustained competitive advantage for our Company.

Our responsibilities

We are committed to being a responsible business. This means using our influence positively to benefit society and the environment, while minimising any negative impacts.

Our local operations

Our success depends on the skills, innovation and contributions of all our employees. We aim to get the best from our employees by treating them with respect, creating a secure and safe working environment, and providing opportunities for training and personal development.

We place great value on our relationship with the communities where we work. Many of our social investment programmes support the communities near our sites and enable our employees to use their time and skills to benefit their local areas.

Our operations have an impact on the environment through the energy and resources we use and the waste we produce. We work hard to reduce the environmental footprint of our business and our products.

Addressing wider issues

Our size and global reach give us influence. We can use this to help address issues of wider concern.

We partner with our customers on social and environmental issues. We support education projects in the countries where we operate, promoting economic development and helping governments to improve their national skills bases.

As a leader in our industry, we can help raise the performance of the defence sector through the standards we set for our suppliers and our collaboration with other defence companies. These include the UK Defence Industry Anti-corruption Forum and the US Defense Industry Initiative on Ethics and Business Conduct.

Governance

Corporate Responsibility Committee statement

The Corporate Responsibility (CR) Committee was established in 2005. It comprises the following members:

Mr Peter Weinberg (Chairman)*, Mr Phil Carroll, Mr Andy Inglis and Sir Nigel Rudd.

Responsibilities

- Assisting the Board on overseeing the development of strategy and policy on social, environmental and ethical matters
- Monitoring and reviewing the Company's performance in managing social, environmental, ethical and reputational risk
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues.

The full terms of reference of the CR Committee can be found at www.baesystems.com or can be obtained from the Company Secretary.

Governance

The CR Committee was in place throughout 2007. All its members were non-executive directors deemed to be independent in accordance with provision A.3.1 of the UK Combined Code.

The Committee normally asks the Head of Internal Audit, Group Human Resources Director, Group General Counsel and Corporate Responsibility Director to attend its meetings. The Committee met five times in 2007.

Activities

The CR Committee has determined that its prime focus should be on ethics and health and safety, as these are areas of particular importance for BAE Systems. However, it also deals with a range of other CR issues, including workforce diversity and environmental matters.

The Committee monitors and reviews compliance with the Company's standards of business behaviour and the work undertaken to ensure that all employees are aware of the standards and understand how to apply them. During 2007 the Committee reviewed the Ethics Helpline and Company ethics awareness programmes, including the results of employee ethics surveys.

As reported on page 14, the Board appointed Lord Woolf, former Chief Justice of England and Wales, to lead a committee to study and report on the Company's ethical policies and processes. During the year the CR Committee met with members of the Woolf Committee to discuss ethics in general and the CR Committee's role in implementing and assuring activity that may result from the Woolf Committee recommendations.

The health and safety of our employees and others who work on our sites or use our products is a key priority for the Company and the CR Committee. We monitor safety performance and have reviewed various aspects of health and safety management within the Company.

During the year the Company has been developing further its risk management processes, particularly in respect of monitoring and mitigating non-financial risks. The Committee reviews annually the output from such processes relating to health and safety, workplace policies, environmental impact, business ethics and compliance with anti-corruption laws and regulation.

The Committee undertook the following activities in 2007:

- received reports from the Internal Audit function on audits undertaken on ethical and environmental matters
- reviewed and approved the approach proposed by the Executive Committee to progress the Company towards a 'best in class' position on safety performance
- reviewed the Company CR Report
- reviewed the CR Committee terms of reference
- liaised with the Remuneration Committee on the setting of CR-related non-financial objectives to be included in the directors' annual bonus plan.

On behalf of the Corporate Responsibility Committee



Peter Weinberg
Corporate Responsibility Committee Chairman



* With Peter Weinberg retiring from the Board, Andy Inglis has been appointed to succeed him as Chairman of the Corporate Responsibility Committee, having first been nominated for appointment to this position by the Nominations Committee.

Our priorities

Our strategy is to deliver sustainable growth in shareholder value by being the premier global defence and aerospace company.

To achieve sustainable growth we must identify and manage long-term risks to our business – including non-financial, operational and reputational risks. As a leading defence company we want to set standards for our industry in the area of Corporate Responsibility (CR) and aspire to reach the standards set by companies in all sectors. As a global business we must ensure our approach is applied consistently across all of our operations, worldwide.

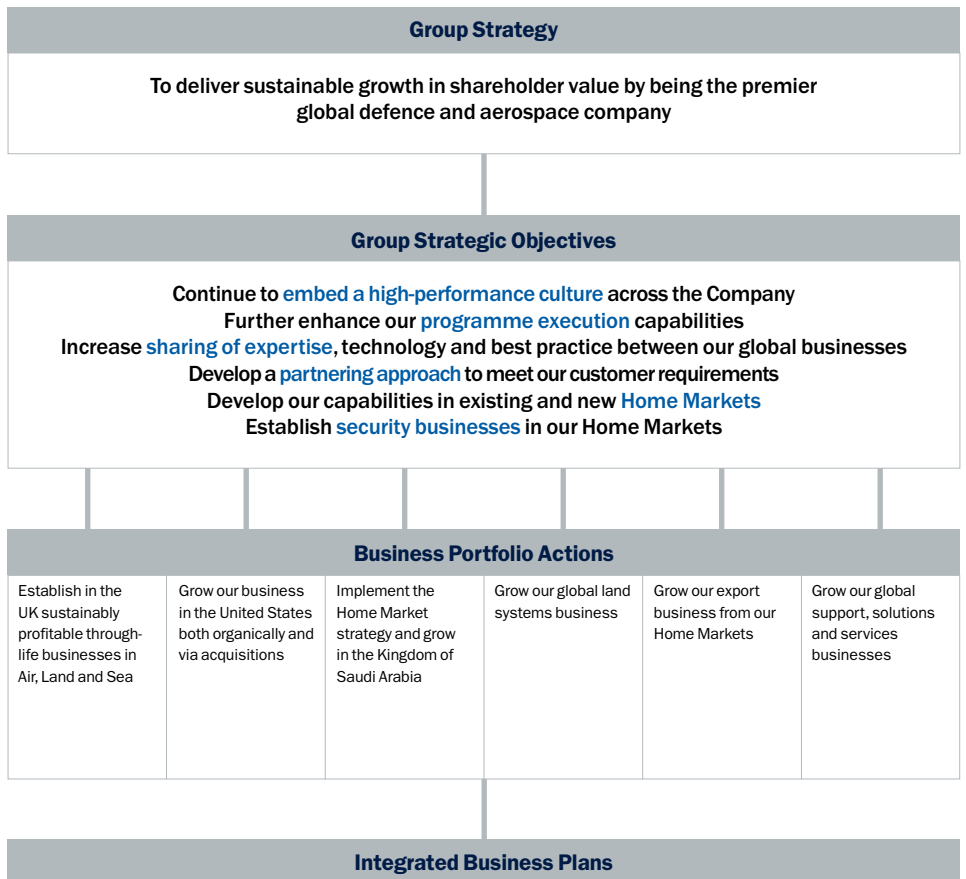
The Executive Committee met in May 2007 to review our CR priorities. The workshop was supported by PricewaterhouseCoopers, who provided information on best practice among leading companies. The Executive Committee considered issues that could have a significant impact on the sustainability of our business, either by directly impacting our ability to operate or by affecting our reputation and the level of trust stakeholders have in our Company. Its analysis took into account the views of key stakeholders, including customers, employees and investors.

Ethics and safety were reconfirmed as our CR priorities – and those where the Company should aspire to a leadership position.

We recognise that to achieve a leadership position requires continual progress. A programme to address this began in 2007 and will continue through 2008. Key aspects of this are:

- establishing an independent view of best practice for ethical business conduct in both the defence sector and across industry
- benchmarking safety performance across all industries – not just the defence sector
- establishing specific objectives on leadership behaviours especially in the areas of ethics, safety and diversity
- setting management objectives in 2008 that drive us towards our desired leadership position in the areas of ethics, safety and diversity.

The Woolf Committee (see page 14) was appointed during 2007 to study and publicly report upon the Company's ethical policies and processes. We will receive recommendations from the Woolf Committee during 2008, which we believe will assist us in meeting our ethics objectives.



Progress towards a leadership position in safety commenced with a review of our safety performance. This review resulted in a four-year plan being put in place to achieve a leadership position in safety (to find out more about this review and way forward see page 20). The delivery of the first part of our four-year plan has been incorporated into our leadership objectives for 2008. Plans include visible senior leadership, establishing specific targets for improvement, and linking safety performance to senior management bonuses.

We will focus on improving performance year on year and set challenging objectives that move the Company further towards best practice in the priority areas of ethics and safety. To demonstrate our commitment, we have increased the proportion of senior executive performance bonuses that are linked to improvements in performance in these areas. In 2008, 12% of the potential bonus will be determined by performance in ethics and safety.

The Corporate Responsibility Committee will review progress against our objectives quarterly.

The Executive Committee also recognised diversity as an increasingly important issue for our business. The sustainability of our workforce and our ability to win and fulfil global contracts depends on our ability to recruit and retain the most talented people from all backgrounds. Our diversity objectives for 2008 include awareness training for senior leaders and the launch of a Company-wide Women's Forum.

From an environmental perspective, climate change is an important issue for all businesses, particularly those operating globally. In 2008, we will measure our carbon footprint and establish a formal position on climate change.

Gaining momentum

We have set leadership objectives to help us achieve leadership performance on our CR priorities and this year have increased the proportion of senior executive remuneration linked to ethics and safety performance. In 2008, 12% of the bonus allocation for our senior executives will be determined by performance in these areas.

Our commitments

Progress

Next steps

Ethics		
<ul style="list-style-type: none"> - Initial ethics awareness training to be completed by new starters within one month of joining - Initial ethics awareness training to be implemented within three months of completion date of any acquisition - Survey to be undertaken to evaluate effectiveness of 2006 UK ethics awareness training package. Implement agreed corrective actions in 2007. 	<ul style="list-style-type: none"> - Ethics awareness training has been introduced to new starter induction processes - New businesses are issued with the Company's ethics guide promptly after acquisition and this is followed up with online or DVD training - A survey was undertaken which indicated that 99% of UK employees have some awareness of our ethical standards. Action plans to address areas identified for improvement have been put in place. 	<ul style="list-style-type: none"> - Senior Leadership to communicate and demonstrate commitment to high ethical standards through employee engagement. Number of engagement events and employees reached to be measured - Develop and roll out a Company-wide 'code of conduct' - Implement the response to Woolf Committee recommendations.
<p>Safety, health and environment</p> <p>2007 safety metrics to improve relative to 2006:</p> <ul style="list-style-type: none"> - Establish appropriate industry benchmarks for each line of business to monitor performance and establish targets to move towards best in class - Company performance (lost days metric) to be better than relevant industry average - Continue to achieve an improvement year-on-year in injuries/lost working time. 	<ul style="list-style-type: none"> - A benchmarking study of BAE Systems' businesses and external companies was performed. The targets thus derived are those set within 2008 objectives - In 2007, we reduced the number of lost days by more than 10% over 2006. We continue to perform at a level better than the industry average, with 8,734 days lost due to work-related injury per 100,000 employees, (compared with the UK manufacturing average of 25,000). 	<p>Continue to drive performance in safety:</p> <ul style="list-style-type: none"> - Reduce the gap between 2007 Company performance and external benchmark by 10% in 2008 (benchmark is 2,000 days lost per 100,000 employees) - Senior Leadership to demonstrate commitment to safety by undertaking formal training and conducting safety audits across our operations. Number of safety audits conducted to be measured - Progress to benchmark safety performance against a five level Safety Maturity Matrix – all businesses to achieve Level 3 by the end of 2008 and have a plan in place to attain Level 5 by the end of 2011 (Level 5 has been benchmarked against leading companies).
<p>Workplace</p> <ul style="list-style-type: none"> - 85% of employee grievances under the UK 'Respect at Work' policy to be resolved through local discussion without proceeding to the corporate process for formal investigation - In each of the Home Markets, move towards establishing a workforce reflective of the national average in terms of gender mix and ethnic diversity, taking into account variations by region and industrial sector. 	<ul style="list-style-type: none"> - 91% of employee grievances were resolved at a local level during 2007 - Diversity action plans were implemented within each of our businesses to reflect their local communities and recruitment populations. 	<p>Create an environment that values and respects the contribution, based on merit, of all members of the communities in which we operate:</p> <ul style="list-style-type: none"> - Senior Leadership to demonstrate commitment to such an environment by attending a Diversity Awareness Training Programme by mid-year - Establish a Company-wide Women's Forum - Develop an action plan to enhance diversity and inclusion by mid-year.

An external view



Mark Wade

Formerly Head of Sustainable Development Policy, Strategy & Reporting, Shell (Chairman)

“BAE Systems has achieved sector leadership in CR. It's time to escape the shackles of compliance/risk avoidance and embrace opportunity and value creation. Putting values at the heart of the business will inspire people and unleash innovation.”



Julia King

Vice President Corporate Responsibility, GlaxoSmithKline

External views help to shape our approach to Corporate Responsibility and influence how we report our progress.

This year, we asked three experienced practitioners in the field of CR to review our report and give their views on our CR Strategy. The Panel met in February 2008 and the session was convened by Context, a CR strategy and communications consultancy.

Panel members

- Julia King, Vice President Corporate Responsibility, GlaxoSmithKline
- Dawn Rittenhouse, Director of Sustainable Development, DuPont
- Mark Wade, formerly Head of Sustainable Development Policy, Strategy & Reporting, Shell (Chairman)

CR Advisory Panel brief

BAE Systems charged the Panel with providing expert independent comment on our CR Strategy, governance and reporting and to offer advice on how to achieve leadership performance on our CR priorities.

The Panel reviewed material on BAE Systems' CR Strategy and draft 2007 CR Report and attended a briefing by Deborah Allen, BAE Systems CR Director, on our progress to date and future ambitions.

The Panel was not asked to provide assurance or verification of systems or performance data.

Views of the Panel

The views of the Panel are set out below without amendment.

Strategy

We are impressed by the way CR Strategy is developed by the BAE Systems Executive Committee, Board and CR Committee. Top level buy-in and leadership is essential. The selected priority areas of ethics and safety rightly reflect the key issues. We applaud BAE Systems' ambition to become a leader in these areas and to help raise standards in the industry. Tying 12% of executive remuneration to performance in CR priority areas is a measure of its determination.

Overall the CR Strategy is logical and aligned with business strategy. However, despite links to operational excellence and leadership in priority areas, it is largely driven by compliance and risk avoidance. We believe this is insufficient.

There needs to be a shift in mindset from a CR Strategy serving business needs to a business strategy conducted responsibly. Likewise it needs to move from compliance and risk avoidance to opportunity and value creation.

This can only occur if there is a solid foundation of values on which all employees frame decisions large and small. Without this the CR Strategy will always struggle to engage the hearts and minds of staff, as it will be difficult to embed policies and standards into the culture of the organisation. It will fail to unleash the drive and innovation necessary for achieving leadership performance.

We recommend that as a priority, BAE Systems communicates and embeds its values more effectively to enable the changes advocated above.

BAE Systems' appointment of the independent Woolf Committee to report publicly on its ethical policies and processes and make recommendations is admirable. How BAE Systems responds will be a measure of the Company's commitment.

People want to work for a company that reflects their values. Leadership in ethical business practices is key to attracting and retaining high-calibre staff at a time of intense competition for talent.



Dawn Rittenhouse
Director of Sustainable
Development, DuPont

Achieving top-level performance in safety requires strong, sincere leadership from senior management as the core element of establishing the safety culture. Clear leadership then needs to be underpinned by rigorous systems, targets and review.

The focus on safety is overdue. Good progress is being made to set global systems and standards. Benchmarking against industry leaders, not just sector peers, has given a valuable perspective. To be up with the best, BAE Systems needs to improve performance by an order of magnitude. This is a huge undertaking. Attention to culture, targets, and a move to leading indicators that help drive progress rather than just recording performance will be needed. The reward for better safety will be reduced injury and improved efficiency, not public kudos. Leadership companies are expected to be safe.

A focus on ethics and safety is appropriate but it does not absolve BAE Systems of its responsibility for managing its carbon footprint and other aspects of environmental performance. The Company's commitment to develop a global climate change policy in 2008 is commendable. Environmental management needs to be supported by improved measurement and ambitious targets.

Leadership companies are expected to have clear policies on human rights. It is insufficient to focus on workplace conditions. We recommend a full scoping of BAE Systems' human rights responsibilities involving wide stakeholder participation.

It is not possible to become a leader without a roadmap showing future aspirations that go beyond compliance. We recommend that BAE Systems develops a five-year plan which includes targets and milestones.

Governance

The existence and remit of the CR Committee is commendable. BAE Systems' numerous other audit bodies and processes show its commitment to developing and upholding global standards. It is less clear how each of these elements relates to one another. Clarity is needed to provide reassurance that they are integrated and fit for purpose.

It is not clear how senior responsibilities cascade to staff. For example, why is it that only executive remuneration is linked to performance on CR priority areas and not all staff? We recommend that staff be engaged more effectively in performance improvement.

It is commendable that governance procedures seek to ensure employee compliance with anti-bribery policies. **But the big challenge for BAE Systems is providing greater understanding of the Company's processes for preventing bribery and corruption.** Delivering this in its governance and reporting would show true leadership in the industry.

BAE Systems uses benchmarking and engagement with external parties to help set priorities. With the exception of the Woolf Committee its engagement has been limited to shareholders, employees, customers and suppliers. **To be a leader on a par with other sectors, BAE Systems should undertake a full stakeholder engagement process to gain a wider understanding of society's expectations.** Longer term the Company should work towards setting up a broad-based Stakeholder Panel to give perspective and challenge to policies and performance.

Reporting

BAE Systems' CR reporting is best in sector but lags behind leaders in other industries. It will need to step up a gear to achieve parity.

We recommend that BAE Systems aligns progressively with the Global Reporting Initiative guidelines and all that this entails. Doing so will address current weaknesses in materiality, completeness, stakeholder inclusiveness, indicators, targets and assurance. It will also encourage a deeper reflection on sustainability issues and the link to value creation.

Short-term attention should be given to setting targets and reporting progress, with commentary, across all areas of current focus. Detail can be put on the web.

Serious consideration should be given to external audit and verification of key data and processes. This will ensure true rigour in systems and data handling and will drive enhanced performance improvement. External assurance will improve credibility.

The report would benefit from more discussion on the legitimacy of the industry and associated ethical issues to better reflect stakeholder interest. More detail on products and services is needed.

At present the report is an underused resource. The best reports lay out the values, vision and commitments of an organisation with a clear roadmap for change directed at addressing stakeholder concerns. Crucially they engage and inspire staff in delivering performance improvement. This in turn leads to enhanced reputation with attendant benefits.

We recommend that BAE Systems shifts the focus of its reporting from shareholders to employees and stakeholders. This will drive lasting change and enhanced business benefit.

BAE Systems' response

We will develop the necessary plans to act on these recommendations and report on progress through our website and in future Corporate Responsibility Reports.

Questions and An



These are some of the key questions on our products, ongoing investigations and issues relating to Corporate Responsibility that we have received from stakeholders during 2007.

Our products

Q: Do you make or sell cluster munitions?

A: BAE Systems does not make or sell cluster munitions and we have not supplied any cluster weapons to any customer since 2004.

Q: Do you use Depleted Uranium (DU) in your ammunition?

A: We no longer produce any ammunition containing DU. Our facility at Featherstone which previously processed DU penetrating rods permanently ceased operations several years ago. The DU penetrating rods that were processed at Featherstone were incorporated into L27A1 ammunition for Challenger 2 tanks. This ammunition remains in service with the British Army.

Q: Do you make nuclear weapons?

A: No. Our Submarine business in Barrow is responsible for the design and manufacture of nuclear-powered submarines on behalf of the Royal Navy, and previously built the submarines that carry the UK's strategic nuclear deterrent. BAE Systems is also involved in early concept work for a next generation of ballistic missile submarine. We also retain a non-controlling shareholding of 37.5% in MBDA which manufactures (in France) the air-launched missile which forms part of the French nuclear deterrent.

Q: Does BAE Systems make or sell shock batons?

A: No, we do not make or sell shock batons.

Q: Does BAE Systems make or sell white phosphorous?

A: BAE Systems does not manufacture white phosphorous. However, we do supply 81mm mortar smoke bombs to the UK Ministry of Defence that contain white phosphorous. These are produced by a subcontractor. This is the only product in our current munitions portfolio that contains white phosphorous.

Ongoing investigations

Q: BAE Systems is being investigated by the UK Serious Fraud Office and the US Department of Justice. Does this mean that there is substance to the allegations of corruption against your Company?

A: The investigation by the Serious Fraud Office into suspected false accounting and corruption is continuing and the Company continues to co-operate with this investigation. In June 2007, the Company was notified by the US Department of Justice that it had commenced a formal investigation relating to the Company's compliance with anti-corruption laws, including its business concerning the Kingdom of Saudi Arabia.

As these are continuing criminal investigations, it would be inappropriate for us to comment on the substance of the investigations. Consistent with this we will not be commenting on any point of substance. This should not be taken as any kind of admission.

swers



Corporate responsibility

Q: Are there any countries you would not sell to? If so, where is the line drawn?

A: The sale of export equipment, whether it is the sale of weapon systems, platforms, equipment, and/or services is highly regulated. Licences will not be granted for countries where sales would be inconsistent with respect to human rights or regional stability, or where there are United Nations arms embargoes or trade sanctions in place. BAE Systems works closely with and maintains a regular dialogue with governments in our Home Markets in relation to all our export sales. All export licence applications are considered by governments on a case-by-case basis and take into account the proposed customer country, the type of product or service to be exported, and its future use. Our applications comply with trade regulations and the requirements for end-user undertakings.

In addition, our Company Strategy sets out the framework for how we will develop the business on a global basis. Within this context, the BAE Systems Executive Committee specifically approves the countries where we will do or pursue business taking into account the Transparency International Corruptions Perception Index (http://www.transparency.org/policy_research/surveys_indices/cpi/2007) in determining the reputational risk associated with operating in a specific country.

Q: Do defence exports contribute to human rights abuses?

A: Defence exports do not lead to human rights abuses. It is individuals and corrupt regimes that instigate abuses to people's human rights.

BAE Systems is subject to laws relating to the export of controlled goods such as the UK Export Control Act and the US International Traffic in Arms Regulations.

Before any export licence is issued, the Home Market government must be furnished with evidence from the purchaser that it is buying the equipment for its own defence purposes, and will not re-export without the consent of the Home Market government. In the UK this is known as an 'End User Undertaking'.

Q: Are you doing enough to tackle your impact on climate change?

A: Our primary contribution to greenhouse gases is through the use of energy. We are placing a specific emphasis on reducing our greenhouse gas emissions and have developed a number of energy reduction initiatives that include employee engagement, engineering initiatives and improved manufacturing efficiencies.

Climate change is an important issue for all businesses, particularly those operating globally and one which the Company needs to address. In 2008, we will measure our carbon footprint and establish a formal position as to actions we would see to take in reducing this footprint.

Q: You aspire to be a leader on health and safety performance. How far are you from achieving this goal and how are you going to get there?

A: Safety is one of our key priorities and we are in the process of implementing a four-year plan for improving our safety performance, which will help us achieve our desired leadership position in 2011. The delivery of the first part of our four-year plan to achieve this has been incorporated into our leadership objectives for 2008 (see page 5). Plans include visible senior leadership, establishing specific targets for improvement and linking safety performance to senior management bonuses.

How our business

We are a global business with major operations established in six Home Markets. We also export defence equipment, technology and software worldwide.

Home Markets

Our six Home Markets are Australia, Saudi Arabia, South Africa, Sweden, the UK and the US. We make an important economic contribution in these markets through our investment in the local industrial base and workforce skills, as well as our support for local economies and communities.

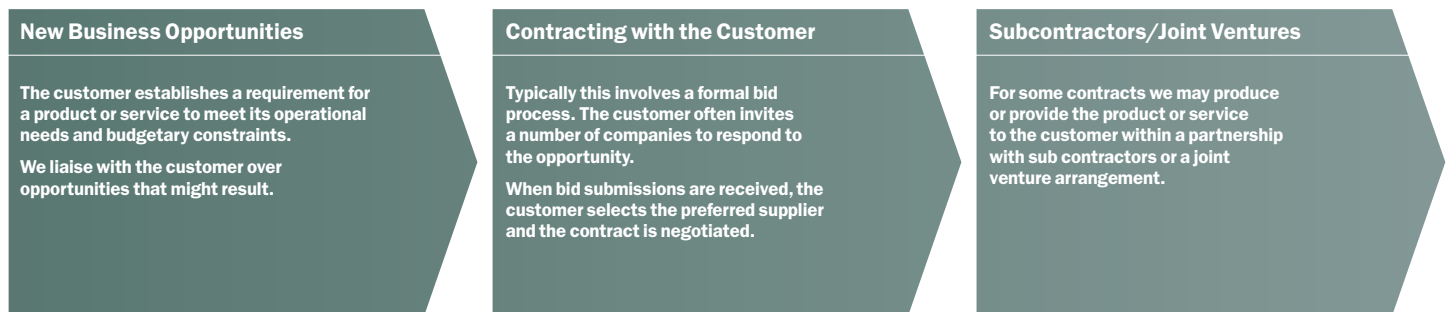
Export Market

Export sales from our Home Markets are an important source of business growth.

Approval from the relevant Home Market government is normally sought before we discuss potential defence business opportunities with an overseas government. A formal export licence is always required before any defence products can be supplied to an overseas customer, and before technical information is released to them.

Example of the contract process

The process shown below is a diagrammatic overview of a complex procurement process and will differ for each market in which we operate.



We are subject to laws and governance governing defence contracts and exports in all countries where we operate. To ensure we meet the highest standards of conduct in our work we incorporate robust internal and external governance in our management systems. Some of these are explained here.

Internal governance

Internal Control

The Operational Framework provides a sound system of internal controls and defines the way we do business and what it means to be part of BAE Systems. It is based on principles of good governance, a set of values, policies and processes that guide our work and a clear system of delegated authority.

Project Governance

We use the Lifecycle Management (LCM) process to provide a structured approach to managing our commitments and investments throughout project and product lifecycles. LCM is based on two types of review that all projects undertake: Regular Business Leadership Team Reviews and Gate Reviews. Its consistent application is critical to our ability to deliver projects to time, cost and quality, enabling us to meet our commitments to our customers.

Business Development

Approval must be sought from our senior management to initiate a new marketing campaign or pursue business in a new market.

Integrity in Business Dealings

Our training and awareness programmes are designed to ensure all employees understand our policies and what is expected of them. We will not tolerate unethical behaviour or attempts to improperly influence the decisions of customers or suppliers.

Operational Assurance Statements

Business Managing Directors are required to confirm their compliance with our Operational Framework every six months. Results are reported to the Board.

Internal Audits

Internal Audit independently reviews the risk identification procedures and control processes implemented by management. It provides objective assurance as to the operation and validity of internal control through a programme of cyclical reviews making recommendations for business and control improvements as required.

works

Offset Regulations

Offsets may be included within an export contract. Offsets (or industrial participation agreements) are requirements on a contractor to provide industrial, commercial or other economic benefits to a country or government as compensation for the purchase of foreign defence equipment or services. The fulfilment of offset obligations takes many forms (see page 15).

These include:

- Direct offsets** – Platform and product-related
- Indirect offsets** – Defence, not platform or product-related, or non-defence related

Currently over 120 countries operate offset and counter trade regulations, including the UK.

Production/Provision of Products/Services

BAE Systems designs, develops, builds, tests and delivers the product to the agreed contractual terms. As a prime contractor and systems integrator, we ensure that a wide variety of components and sub-systems, sourced worldwide from our own and our suppliers' facilities, function as a complete solution to meet the contractual requirements. We engage continually with our customer throughout this process.

Upgrade

The solution is delivered. Depending on contractual arrangements, BAE Systems may provide support to the customer throughout the life of the product including training, maintenance and product upgrades.

Disposal/Renewal

When the product comes to the end of its lifecycle, depending on contractual agreements BAE Systems may assist in the disposal of the product, or re-contract for the provision of a new product, or both.

External governance

End User Undertaking

Before any export licence is issued, the Home Market government must be furnished with evidence from the purchaser that it is buying the equipment for its own defence purposes, and will not re-export without the consent of the Home Market government. In the UK, this is known as an 'End User Undertaking'.

Export Licence Compliance

We need a licence to export any goods, technology or software specially designed or modified for military use. Dual use commercial items with a military application require a licence or regulatory exemption. In granting licences, governments take into account factors such as the purchaser's respect for human rights, the risk of diversion and the effect on regional stability.

Laws, Regulations and Sanctions

All aspects of our operations are subject to applicable laws, regulations and sanctions. These include laws governing the export of controlled goods such as the UK Export Control Act, the US International Traffic in Arms Regulations and laws implementing the OECD Anti-Bribery Convention and the US Foreign Corrupt Practices Act.

External Audit

External audits present an unbiased and independent evaluation of our Company.

Government Relations

We maintain regular dialogue with governments in our Home Markets in relation to our contracts and export sales.

Ethics

Ethical conduct is important in all business sectors and is increasingly fundamental to business operations. This is a particularly complex and high profile issue for the defence industry because of the products we make and the high value of the contracts involved.

The defence industry is highly regulated, as the chart on page 10 and 11 demonstrates. We are subject to the law and government regulations wherever we operate. In addition we implement our own long-standing business ethics policies and procedures. These apply throughout our business, govern interactions with our customers and partners, and define the way we expect our employees to operate.

We are confident that our approach is robust but we are not complacent and we continue to look for ways to strengthen and improve our programmes in line with best practice across both the defence industry and other sectors.

Our approach to ethics

Key elements of our approach include:

- Our Operational Framework, ethical principles and anti-corruption policies apply to all employees
- Ethics training for all employees and regular refresher courses for employees involved in business development and government affairs
- Our ethics booklet and intranet site which provide up-to-date information and guidance for employees
- An independent Ethics Helpline for employees to report suspected cases of unethical conduct. Calls to the helpline are reviewed by senior management and reported twice a year to the CR Committee
- Extensive compliance and assurance processes.

Our ethical principles

Accountability: we are personally answerable for our conduct and actions.

Honesty: there is no substitute for the truth.

Integrity: we say what we do, we do what we say.

Openness: when questions are asked, we will be frank and straightforward in our answers.

Respect: we value and treat each individual with dignity and thoughtfulness.

Activity in 2007



In 2007, we appointed Lord Woolf, the former Lord Chief Justice of England and Wales, and an independent expert review committee to advise on standards of best ethical business practice and what we need to do to achieve them, see page 14. In addition we have implemented a number of changes during 2007 as part of our drive for continual improvement.

Marketing advisers

We reviewed our processes for appointing and managing marketing advisers and implemented a number of process improvements. These are also being reviewed by the Woolf Committee.

Ethics survey

We conducted an employee survey in the UK to assess awareness of our ethical standards. Over 16,000 employees took part (30% more than in 2005). The results showed that awareness of ethics has increased since 2005.

Key findings included:

- 99% of employees have some level of awareness of the Company's ethical standards
- 82% believe the Company does enough to promote its standards internally
- 84% feel that the training has helped them improve their understanding of ethics within their day-to-day jobs.

Areas identified for improvement include: our processes to encourage the reporting of ethical breaches; and visible senior leadership on ethics. Action plans are being implemented and we will monitor progress through our 2008 Employee Opinion Survey.

Applying our policies

We are committed to meeting the highest ethical standards in our dealings with others. We will not tolerate unethical behaviour or attempts to improperly influence the decisions of customers or suppliers.

Business Development

Our main regions for business development (including marketing activity) are the UK, US, Asia-Pacific, Europe and the Americas and Middle East, Africa and India.

All staff involved with business development are required to undertake a training course on the prevention of corruption, with refresher training every two years. Over 5,500 employees have undertaken this training since 2001. Training is tracked to help ensure compliance.

The use of advisers is part of normal business practice for most industries. We work with advisers and specialist consultants who provide knowledge of the local defence procurement process and regulatory, financial and cultural support.

Our Advisers Policy governs the selection, assessment, appointment, renewal and ongoing management of relationships with advisers.

We are aware that some external stakeholders perceive working with third parties as a potential route to corrupt practice. We rigorously apply our policies to prevent this and protect both our own reputation and that of those we work with.

Payment terms are reviewed by our compliance teams on a regular basis to confirm that remuneration to advisers is proportionate to the services carried out. We also confirm that advisers are operating in line with our standards and that there continues to be a genuine business need for retaining their services.

Regulation and legislation

Our export compliance teams in each market are responsible for ensuring we comply with defence export controls and associated legislation.

Governments determine the countries to which defence exports are permitted at any one time. Their judgements balance a range of issues, such as national interest, economic, strategic and human rights.

Monitoring and compliance

Our Internal Audit department carries out assessments of our business units including compliance with our ethical principles and policies. Audits are targeted on a risk basis according to the likelihood of a breach of policy occurring and the potential impact such a breach would have on our business.

It is important that we ensure compliance with ethical standards at all levels of the Company. Managing Directors and Functional Leaders are required to complete an Operational Assurance Statement (OAS) every six months confirming that their parts of the Business have complied with our policies including those covering Fraud Prevention, Ethics, Export Controls, Working with Advisers, and Hospitality, Gifts and Personal Interests.

A summary of the OAS results is reported to the Audit Committee and the Board. Businesses that do not reach the minimum standard are required to implement action plans for improvement.



Reviewing our policies on ethical conduct

Business acquisitions over the past three years have brought many new employees into BAE Systems. We must ensure that all employees understand what is expected of them and how to deliver this. We initiated a review of our policies regarding ethical conduct in 2007 to ensure they remain appropriate for our changing Business and to provide new ways of communicating them to our employees through a global set of standards. We will act on recommendations from the Woolf Committee in this regard and plan to introduce a revised code at the start of 2009.

Ethics training

We continued to roll out ethical awareness training to employees worldwide through brochures, online training, DVDs and classroom sessions. At the end of 2007 training had been completed in the UK, US, South Africa and Australia. Our ethics DVD and online training have been translated into Arabic and roll out is underway in Saudi Arabia. A Swedish translation has been developed and will be introduced in 2008.

Ethics helpline

In 2007, we received 327 calls to our ethics helplines and email addresses.

Disciplinary action

260 employees were dismissed for reasons relating to unethical behaviour. Reasons for dismissal included misuse of Company IT, fraud, inaccurate labour charging and threatening behaviour. More detail is available in our data file on page 24.

Transparency

We place a high value on our reputation and the trust our stakeholders have in our Company. We want them to continue to be confident that BAE Systems is a well managed company with rigorous standards of ethical business conduct.

In countries such as the US, the general public perception of the defence industry is positive. In other countries, such as the UK, views are more mixed – trust in the industry is lower and media coverage is more negative in tone.

Because our business directly relates to matters of national security, transparency can be difficult for our sector. In addition, legal reasons prevent us from commenting on official investigations. But openness about our business practices is the best way to maintain stakeholder confidence and counter perceptions that our sector is prone

to corruption. We recognise that we need to provide facts and information on how the industry actually operates and evidence on how our ethical standards are applied in practice.

Commitment to transparency

These are some of the ways we implement our commitment to transparency:

Seek independent advice and opinion

The Woolf Committee was appointed during 2007 (see below) to provide expert views on best practice in ethical business conduct. We have committed to act on its recommendations.

Provide evidence that we implement and uphold our policies

We report our progress annually through this report, including the number of employees dismissed for unethical conduct (see page 24).

Demonstrate continual improvement

We have identified a number of areas for improvement through our annual UK ethics survey and will monitor improvement through subsequent surveys (see page 12). In the US we are participating in the 2008 round of the Defense Industry Benchmark (DIB)

survey conducted under the sponsorship of the Defense Industry Initiative on Ethics and Business Conduct (DII). This survey was first conducted in 2005 and provides an ability to benchmark the Company against its peers in the US defence industry. We will report the outcome in our next CR Report.

Communicate our policies and standards

All employees receive training on our ethical policies and new employees receive training within one month of joining. Newly acquired businesses receive an ethics guide promptly after acquisition and all employees receive ethics training within three months.

We are currently reviewing our policies on employee conduct to ensure they remain effective and are developing a new global code of conduct to help employees better understand our approach and expectations.

Be open about our activities and operations

We provide information and performance data through this report, our website (www.baesystems.com) and our Annual Report, covering safety, environment, Company giving, ethical issues, and people development.

The Woolf Committee

What is it?

An external, expert, independent committee appointed by the Board to study and report on our ethics policies and processes and make recommendations aimed at achieving a leadership position in ethical business practice amongst corporate industry peers.

Why has it been convened?

We want to be in a position to provide further assurance to our customers, investors, employees and communities that our policies are subject to continuous improvement and set the pace for the international defence industry.

Members

- The Rt. Hon. The Lord Woolf of Barnes (Chairman), former Lord Chief Justice of England and Wales
- Sir David Walker, Senior Adviser and former Chairman of Morgan Stanley International Ltd.
- Philippa Foster Back OBE, Director of the Institute of Business Ethics

- Douglas N Daft AC, former Chairman and Chief Executive of The Coca-Cola Company
- Dr Richard Jarvis (Secretary to the Committee), former Secretary to the Committee on Standards in Public Life.

Objectives

The Committee was appointed to:

- review the Company's ethical policies and processes, and to review the Company's adherence to applicable anti-corruption legislation, including relevant international treaty obligations
- reach a judgement as to how the Company's policies and procedures benchmark against industry standards, whether they are sufficiently robust to ensure compliance with its ethical business policies generally and in particular to detect and prevent violations of anti-corruption laws
- to make recommendations for any remedial actions it believes the Company should take.

The Company has provided full access to the Woolf Committee on information relating to our ethical business practices. The Committee has met with senior BAE Systems executives in the UK and the US, our CR Committee, Trade Union representatives and employee groups.

Findings and recommendations

The Committee plans to publish its written report with conclusions and recommendations later in 2008.

The BAE Systems Board has committed to act on the Committee's recommendations.

This will be monitored by our CR Committee.

Public policy

Lobbying – engagement with governments and decisionmakers to influence public policy on defence-related and other business issues – is an essential and responsible business activity. We communicate with politicians in all our Home Markets to keep them informed of our activities.

The lobbying activity and political influence of corporations has become a subject of interest to some of our stakeholders, including some investors. We aim to be open about lobbying conducted by BAE Systems. Sometimes we are not able to be as open as we would like, for example, due to commercial confidentiality and requirements of national security.

We do not make corporate political donations.

Lobbying in the UK

In the UK, we speak regularly to MPs who have an interest in defence or other business issues or represent a constituency where we have operations and employees. We provide information about our activities, products and services, and welcome requests for information and visits to our sites. During the procurement process, we seek to inform MPs

of the products or services we are offering and the value we contribute to the economy (see page 23).

Lobbying in the US

We lobby US Government officials (legislative and executive branches) to advocate policies and programmes that are important to our customers and end users (including the armed services), our employees and our shareholders. We communicate with our customers to ensure our lobbying activities address their needs and evolving requirements.

In addition to direct lobbying, we work in partnership with major trade associations (e.g. the US Aerospace Industries Association) to advocate positions that are beneficial to the defence and aerospace communities at large. One example of industry-wide efforts is the recent lobbying for Acquisition reform.

We report our US lobbying activities to the US Government, as required by law.

We do not make corporate donations to political candidates or parties. We manage a Political Action Committee (PAC) that enables employees to make bi-partisan contributions to candidates for Congressional seats and to

party organisations that support Congressional races. The PAC is an employee-funded effort that is totally voluntary and is managed in full compliance with Federal Election Commission requirements. Contributions made through our PAC totalled \$534,490 in 2007.

Working with others

We participate in initiatives to improve standards across the defence industry. For example, we are members of an international Defence Industry Anti-Corruption Forum. Members of the Forum, including companies and trade associations, met twice in 2007 to exchange views and best practice. The Company has agreed a set of common industry standards for members of the Aerospace and Defence Industries Association of Europe. The standards cover issues such as the prevention of corruption, working with advisers, political donations and ethics training. This is a significant step forward for the sector in Europe.

In the US we are a signatory to the Defense Industry Initiative on Ethics and Business Conduct (DII). The DII is a voluntary self-governance organisation of defence companies, founded in 1986 and recognised by the US Department of Defense.

Offsets in practice

Offsets (or Industrial Participation Agreements) are used in many different sectors. Thirty years ago fewer than ten governments had formal offset requirements for defence contracts – today over 120 countries (including the UK) operate offset and counter trade regulations. Offsets have become an important element of the evaluation process for new defence contracts.

There are typically two categories of offsets: direct offsets that relate to the products we are supplying and indirect offsets which may be unrelated to defence. These are some examples:

- A direct offset agreement in support of a contract to supply aircraft to the Finnish Air Force.

The first four aircraft were delivered direct from our UK factory. The remaining aircraft were shipped in kit form to a Finnish partner for assembly. Some items were also manufactured in Finland. This created employment in a high-priority industrial area and helped the Finnish Air Force acquire a degree of self-sufficiency in the longer-term support and maintenance of its aircraft.

- An indirect offset agreement in support of a potential campaign to sell aircraft to Brazil.

This agreement would help the CTA, a Brazilian air force research and development facility, acquire 'Smart Structures' techniques – used in aircraft maintenance and other industrial processes outside of the aerospace industry.

An indirect non-defence related offset as part of our contract to sell the Light Gun L119 (a towed howitzer gun) to the Thai Government.

We developed three offset projects that supported the Thai Government's social and economic priorities:

- **Smart Schools programme** – Working with the Thai Ministry of Education, we delivered six SMART classrooms to help students develop their technology skills
- **Low Cost Housing project** – We partnered with a UK construction company to help the Thai National Housing Authority adopt building processes that allowed 8,000 high-quality buildings to be constructed quickly at a low cost
- **Rice Trading project** – We worked with the Thai Government to seek new markets for Thai

commodities and increase exports to existing markets.

In carrying out our offset agreements, it is important that we identify projects that support customer government priorities and that we deliver them in a timely manner.

We have a number of internal policies and processes that govern our offset agreements. These include:

- BAE Systems' Offset Policy – covers management and reporting responsibilities. Businesses must confirm their compliance with the policy every six months through the Operational Assurance Statement
- Offset Handbook – provides guidance on the process for planning and managing offsets
- Our Process for the Approval of Third Party Offset Suppliers
- Industrial Offset Group – the group's role is to improve offset performance, review and update our offset policy and share best practice across the company
- Offset Awareness Course for relevant employees.

Our operations &



The above diagram is a computer generated image (CGI)

Major injuries recorded page 27

Days recorded lost page 27

Total recorded injuries page 27

Workplace

All our employees have the right to work in a safe environment where they are treated with dignity and respect. Our workplace policies reflect the principles set out in the Universal Declaration of Human Rights and we have processes to deal with instances of inappropriate or unacceptable behaviour.

Safety is one of our key CR priorities (see page 18). All sites must comply with our Safety, Health and Environment Policy, and demonstrate continual improvement in performance. We strive to create a workplace where risks are quickly identified and managed, and unsafe practices are not tolerated.

We believe a diverse workforce drives innovation and helps us maintain competitive advantage. We seek to recruit a culturally diverse workforce where people bring different but complementary values, attitudes, talents and knowledge to their jobs. We are committed to equality of opportunity for all employees.

Engaged and motivated employees are more productive. We conduct a global employee survey every two years – next due in 2008 – to gauge opinion on working at BAE Systems and

identify areas where we can improve. We consult with our staff through employee representative bodies and trade unions to resolve workplace issues, develop our employment policies and compete for new contracts.

We want our employees to develop successful careers at BAE Systems and we invest in training to help them reach their full potential. We encourage talented young people to join the company as apprentices and graduates to ensure we have a pool of skilled workers coming up through the business.

2007 highlights

- 97,500 employees across five continents
- 54,874 employees undertook 317,941 e-learning courses totalling 475,351 hours
- Over 3,500 nominations received for our annual Chairman's Award Scheme that recognises employees' talent and skills
- Reduced our total recorded injury rate (per 100,000 employees) by 7%
- Proportion of female employees (now 21%) continues to rise gradually
- 53% of our workforce in Saudi Arabia are Saudi nationals
- Working with Disability Works in Australia to improve employment opportunities for people with disabilities.

Working with others

We recognise that our responsibilities extend beyond our own employees and that our choice of suppliers, partners and contractors can affect the reputation of our business. We expect the companies we work with to conduct their business ethically, treat their employees fairly, ensure high standards of health and safety and manage their environmental impacts.

We share best practice and work in partnership with strategic suppliers to improve performance through our Supplychain Excellence programme. These key suppliers are assessed every two or three years on a range of criteria – including CR issues – and we help them develop plans to improve.

We are also working with contractors on our sites to emphasise the importance of health and safety – one of our key CR priorities. In future, we intend to report on our contractors' safety performance.

2007 highlights

We are working through the North West Aerospace Alliance to help build a strong, vibrant supply chain in the North West of the UK. BAE Systems and two other manufacturers have each committed ten senior mentors to work with local small and medium-sized enterprises. Funded by the Regional Development Agency, the aim of the programme is to develop 45 world-class suppliers in the area over the next four years.

CR impacts



Employee diversity page 25

Energy consumption page 26

Community investment page 28

VOCs page 26

Energy use page 26

Waste page 26

CO2 emissions page 26

Environment

All our activities, operations, offices and products have an impact on the environment. They use natural resources and raw materials and they generate waste and emissions. We are committed to managing and minimising these impacts wherever practicable.

Our designers consider and take steps to mitigate potential environmental impacts throughout the lifecycle of a product – from manufacture through to use and end-of-life.

Our Product Environmental Working Group addresses issues relating to material use, maintenance and end-of-life product disposal (see page 20). The Group is reviewing our compliance with the EU REACH (Registration, Evaluation, Authorisation and Restriction of Chemical Substances) Directive and working with the UK Ministry of Defence to develop a common approach.

Climate change is an increasingly significant global sustainability issue. In 2008, we will measure our carbon footprint and establish a formal position on climate change.

Our main impact on climate change is through greenhouse gas emissions from energy use. We are implementing a number of initiatives to

reduce our energy use by improving efficiency in engineering and manufacturing processes. We also encourage employees to cut unnecessary energy use and to turn off lights and monitors when not in use.

We support industry and national efforts to tackle climate change such as the EU Emissions Trading Scheme. We also participate in the UK Ministry of Defence Sustainable Action Plan for Defence to improve the environmental sustainability of defence products and services.

2007 highlights

- **Pledge A Tonne campaign launched by UK Land Systems, asking every employee to cut CO2 emissions by making simple but effective changes at home and at work, such as turning off lights and heaters**
- **Nine UK sites participate in the EU Emissions Trading Scheme and traded 4,500 tonnes of carbon in 2007**
- **Surface Fleet Solutions established Sustainability workshops for its Facilities Management business, so that it can start designing buildings for its customers to be energy efficient, use sustainable materials, reduce in-service costs and maintenance, and employ the latest proven green construction technologies**
- **In 2007, Platform Solutions in Johnson City, New York achieved ten years of Environmental Management System excellence by passing its 20th consecutive semi-annual ISO 14001 surveillance audit, with no findings or non-conformances.**

Community and education

We give money, time and equipment to support charities, education activities and the communities in which we work. At corporate level, our giving is focused on education and support for the armed forces. In addition, our sites support a wide range of local charities and community initiatives.

Education is extremely important to the long-term sustainability of our business and our ability to recruit talented people. In many countries there is a shortage of graduates with technology and engineering skills. We support education programmes that encourage young people to take an interest in engineering, science and technology and consider a career in these areas.

A number of our employees volunteer to support community projects or education programmes – from gardening to providing professional advice and IT training, running drama workshops or mentoring students.

2007 highlights

- **£6.1m invested in local communities around our sites, supporting charities and educational establishments**
- **Employees volunteered 4,310 days to support community projects**
- **Science and technology education programmes in Australia, Saudi Arabia, South Africa, the UK and the US.**

Health and safety

Ensuring high safety standards for our employees and others who work on our sites or with our products is one of our key CR priorities. This was reconfirmed by our Executive Committee in 2007. Our approach to safety is one of zero tolerance of an unsafe workplace and unsafe working practices.

Progress in 2007

The Company confirmed its commitment to reach a level where its safety performance would be comparable with the leading companies in this area.

As a first step we benchmarked our safety performance against best practice in the defence and other industry sectors. During the year we also instigated a number of safety improvements. For example, we:

- Incorporated safety into our leadership objectives for 2008 (see page 5)
- Assessed our safety management practices against the findings of the Baker Report on the BP Texas City disaster. Each of our businesses has agreed an action plan to address any shortfalls in our safety management practices. Progress will be reviewed every six months

- Reviewed our process for identifying and prioritising high risk activity, in line with recommendations made in the Baker Report
- Increased the detail in our safety report which is reviewed by senior management teams
- Extended and standardised the level of safety information provided by each business in its quarterly safety report to facilitate consistency of performance review
- Established a Pandemic Steering Group to help ensure we are adequately prepared for a potential global flu pandemic
- Held our annual safety and environment conference for employees from across our businesses to share best practice.

Safety at BAE Systems



A safe working environment and healthy employees are vital to the success of our business.

The majority of our employees are involved in engineering and manufacturing. They design and build heavy machinery – ships, planes, military vehicles – and weapons. Health and safety risks in our operations include working at height, manual handling, respiratory and skin irritation, hand-arm vibration syndrome and noise. Additional safeguards are required at our sites in the UK and the US that handle explosives and nuclear energy.

Our office-based employees are exposed to other risks, such as repetitive strain and ergonomic issues from working with display screen equipment.

Slips and trips, manual handling and collisions with objects continue to be the most common causes of injury (see page 27).

How we manage health and safety

All sites must comply with our Safety, Health and Environment (SHE) Policy, which is approved by the Executive Committee and the Board. Line managers are responsible for implementing our policy and delivering good standards of safety management. They are supported by teams of specialist health and safety professionals.

We place great emphasis on each employee understanding his or her role in creating a safe working environment. One example is our Hattiesburg site in Mississippi, US. All employees have been nominated as safety officers to raise awareness and encourage reporting of potential hazards. In 2007, there were more than 180 potential hazards reported and corrected each month. This contributed to the site recording no recordable injuries in 2007.

We aim to help all injured or ill employees recover and return to work quickly. For example, in 2007 we increased support for injured employees at our shipyards in Scotland including providing access to physiotherapy and specialist medical support. This helped reduce the average number of days it took an employee to return to work by 75%.

We are working in partnership with the UK Health & Safety Executive (HSE) to develop best-practice standards on key safety issues in the manufacturing sector: contractor management, hand-arm vibration, working at height, working in confined spaces, manual handling, and slips, trips and falls. In 2007 a joint team from the HSE, Trade Union safety representatives and our safety management teams audited safety practice and performance at eight sites. The process provided valuable opportunities to learn from our partners and exchange good practices between sites.

Changes in our business model can have implications for safety. For example, increasingly our employees are working on customer bases providing maintenance and support throughout the life of our products. We work closely with our customers to ensure that the necessary standards of safety and training are in place for our employees at such sites. Encouraging the right culture of partnership and exchange of good practice is key.

We recognise that our responsibilities extend beyond our own employees. This includes contractors working on our sites, our suppliers and partners. We aim to work with all groups to mutually improve standards. A key focus in 2008 continues to be safety performance of contractors on our sites. We intend to include this in our future external reporting on safety performance.

Cause of major injuries recorded 2007¹



13.6% falls from height – up to and including two metres

4.6% exposure to an explosion

4.6% falls from height – over two metres

4.6% contact with moving machinery

45.5% slips, trips or falls on same level

6.8% struck by moving vehicle

4.6% injured while handling, lifting or carrying

6.8% struck by moving, including flying/falling, object

4.6% strike against something fixed or stationary

2.0% contact with electricity or electrical charge

2.3% exposure to, or contact with, a harmful substance

Footnotes

¹ This recorded data is derived from internal systems and is not subject to external verification or audit.

Our operations

Reviewing our approach to safety

Our Executive Committee has determined that safety is a key priority for our business.

Our ambition is to achieve safety performance on a par with the best global companies from all sectors. In 2007 we assessed our current approach to determine what steps we need to take to achieve this goal. This included:

- Reviewing our current safety performance and goals
- Comparing safety performance across our business units
- Benchmarking our performance against leading global companies
- Comparing our approach and performance to recognised safety best practices
- Reviewing the safety goals and strategies set by leading companies.

Findings

We found that we can demonstrate incremental overall year-on-year improvements in safety performance and our injury and incident rates are lower than the UK Health & Safety Executive average for our sector. Our performance is comparable with or exceeds a number of other aerospace and defence companies. However, progress is not consistent between our business units and our performance lags behind that of leading global companies from other sectors.

Actions

We have developed a four-year plan for improving our safety performance. Initial focus areas include: visible senior leadership, establishing specific targets for improvement and linking safety performance to senior management bonuses. These have been incorporated into our 2008 leadership objectives (see page 5).

To achieve these goals we need to ensure we share good practice in the area of safety with partners, suppliers and contractors.

Process safety

Process safety is particularly important at our site in Barrow in the UK which handles and stores nuclear material for powering submarines and in our munitions businesses in the UK and the US that handles and processes explosive material. Both of these operations are recognised as high hazard and subject to extensive regulations and compliance checks. The managing boards of these businesses frequently review compliance reports, incident records and improvement plans.

Product safety and stewardship

We apply considerable attention to the design, manufacture and maintenance of our products to ensure the intended user can have confidence in their integrity and reliability. Product safety for our business includes ensuring that our products are safe to handle and transport, and developing weapons systems that are as accurate as possible when used. We have a dedicated Product Safety Group, which reports directly into our Engineering Council. All engineering staff receive training on product safety.

Anticipating and preventing safety risks



In 2008 we will close our Bridgwater explosive site due to the transformation and restructuring of our Land Systems Munitions business. During times of major organisational change accidents resulting from human error are much more likely to occur. To reduce this risk Bridgwater launched a safety awareness campaign tackling safety issues associated with the closure.

As a first step, the site commissioned a risk assessment to determine the factors influencing employee behaviour in the run up to the closure.

Site supervisors attended training sessions and were given material to engage employees on safe working practices. Safety material used four memorable cartoon characters depicting stereotypes of unsafe working practices. Monthly briefings were held for all employees and contractors, to ensure consistent safety messages were communicated across the site and enable any issues raised to be dealt with promptly.

There are a number of environmental issues associated with our products. For example, ordnance left over from wars or military training can have a significant impact on the environment and potentially on the health of local communities. Disposal of old ships and aircraft can damage the environment if hazardous substances are not identified and disposed of safely. Emissions from military vehicles and aircraft can contribute to climate change. Our business is subject to an increasing amount of environmental regulation including the EU Directives on Waste Electrical and Electronic Equipment and the Reduction of Hazardous Substances.

We have established a Product and Environmental Working Group to consider sustainability issues associated with the through-life development, updates and end-of-life disposals of our products.

In 2007 product environmental protection guidance was produced which will help ensure that a product's potential environmental impacts are considered during the design phase and that steps are taken to reduce these impacts throughout the lifecycle.

Programmes are in place to reduce or eliminate the use of hazardous substances (such as cadmium and asbestos).

We held two seminars during 2007 for employees to hear from internal and external experts on product safety best practice and the challenges associated with producing environmentally sustainable defence products.

Celebrating 1.4 million injury-free hours at Kingsport, Tennessee



Our Ordnance Solutions team (pictured above) at the Holston Army Ammunition Plant in Kingsport, Tennessee, celebrated 1.4 million hours without lost time injuries in July 2007, including 350,000 hours without a single recordable injury.

The Ordnance Solutions team manufactures explosives for the US Department of Defense. Safety is always a top priority for management but this impressive safety record could only be achieved by getting every one of the site's 460 employees involved.

Safety is included in every employee's annual performance goals and evaluation. All employees are encouraged to raise any concerns for discussion at the monthly Employee Safety Committee – with representatives from across Ordnance Solutions. Any significant issues are elevated to the Senior Management Safety Advisory Committee that meets monthly to discuss safety performance, audit results and incident investigations.

Other initiatives include SafeStart, a training programme to change employee attitudes to safety by raising awareness that certain states of mind – such as tiredness, complacency, frustration or rushing – increase the risk of unsafe practices. The site also runs a preventative exercise programme which encourages employees to take a few minutes to stretch before starting work, to help avoid injury.

Performance summary

We collect data^{1,2} on ethics, diversity, environment, health and safety and community investment to help us monitor our Corporate Responsibility performance and identify areas for improvement. The data are recorded by the businesses and collated centrally for review. Explanations of trends are provided on the following pages. Specific notes are recorded below.

	2005	2006	2007
Economic			
Revenue	£11,019m	£12,333m	£14,309m
Operating profit	£761m	£1,054m	£1,177m
Equity dividends paid in year	£315m	£346m	£396m
Wages and salaries	£2,989m	£3,274m	£3,353m
Pension costs	£233m	£253m	£240m
Employee numbers ³	100,100	88,600	97,500
Ethics¹			
Ethics enquiries from employees	367	410	327
Diversity¹			
Gender diversity:			
Male employees	81%	80%	79%
Female employees	19%	20%	21%
Ethnic diversity:			
White	88%	87%	82%
Non-white	12%	13%	18%
Age diversity :			
Under 25	7%	7%	8%
26 to 35	18%	18%	17%
36 to 49	44%	42%	39%
50 to 59	25%	26%	27%
60+	6%	7%	9%
Environment¹			
Energy use ⁴ (Gwh)	1,767	1,742	1,706
CO2 emissions (million tonnes)	0.58	0.57	0.55
Waste ('000 tonnes)	57	105	129
Waste recycled ('000 tonnes)	37	67	42
Volatile organic compound emissions (tonnes)	610	742	642
Health and safety¹ (per 100,000 employees)			
Major injuries recorded	55	47	48
Days recorded lost to work-related injuries ⁵	8,774	10,204	8,734
Total recorded injuries to all employees	6,009	4,788	4,454

Footnotes

- 1 This recorded data is derived from internal systems and is not subject to external verification or audit.
- 2 In 2007 we acquired Armor Holdings. The integration of Corporate Responsibility data from that business is underway and will be reported in 2008.
- 3 Including share of equity accounted investments.
- 4 Our energy use is directly related to volumes of product manufacture and throughput of specific projects. The decrease shown in energy use, despite increases in volume and throughput, reflects a specific focus at a number of businesses on energy management and efficient operations.
- 5 The decrease in 2007 over 2006 in days recorded lost due to work-related injuries reflects a much improved performance in our Surface Fleet Solutions business, which reduced the number of days lost by 75% over 2006 levels.

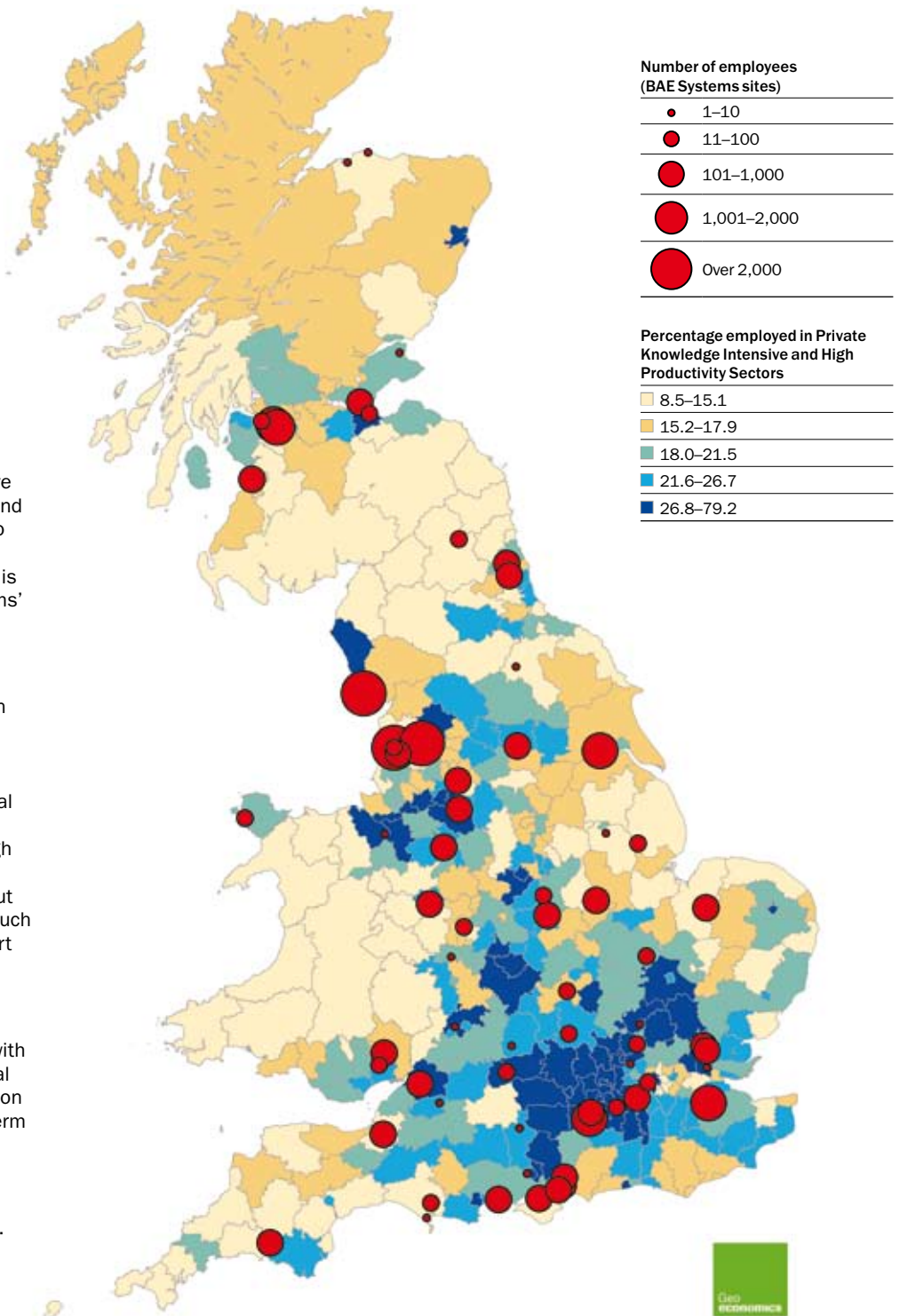
Economic impact – UK

We recognise that our operations and presence in an area have the potential to have an impact on the surrounding communities and possibly wider regional areas. We continue to review and understand our socio-economic contribution. The case study presented here is an extract from a recent study on BAE Systems' contribution to the UK economy.

In 2007, we commissioned the research consultancy, Oxford Economics, to conduct an assessment of BAE Systems' contribution to the UK economy. They were supported by Geo-economics who provided a socio-economic assessment of our impacts. The study – based on data from the 2006 financial year – concluded that we make a substantial direct contribution to the UK economy through employment, value added, taxes paid, investment and R&D spending (see table). But the Company's overall economic impact is much greater than this as our activities also support other businesses including our suppliers.

The study found that our investment in R&D offers potential applications to other businesses and consumers. This, together with our investment in community and educational partnerships, makes an important contribution to the UK's 'knowledge economy' and long-term economic growth.

A key finding of the socio-economic study was that our business is helping to reduce regional inequalities within the UK (see map). Three-quarters of our direct employment and 45% of our purchasing spend is with suppliers in the six regions targeted by the UK Government for increased growth. In particular, our strong presence in the North West of the UK goes against the traditional North-South divide in the UK.



Summary of BAE Systems' economic impact on the UK economy in 2006

	Direct contribution	Indirect contribution	Induced contribution*	Total contribution
Employment	35,096	46,190	24,000	105,286
Investment	£158m	£220m	–	£378m
Exports	£4,100m	–	–	£4,100m
Taxes	£498m	£193m	£100m	£791m
Value added	£2,420m	£2,190m	£1,200m	£5,810m
R&D spillover	Adds cumulative total of 1% to UK GDP over 14 years			
Community benefits	Long-term benefits of 2006 global Community Responsibility spending equate to £11.6 million			

*From income spent by employees supported by BAE Systems

Monitoring our performance

We monitor our Corporate Responsibility performance through sector benchmarking to track our performance and help us better manage key environmental and social impacts. In 2007, our performance level in the Dow Jones Sustainability World Index was similar to our 2006 scoring.

We are reviewing the reasons for the lower social factors rating in 2007, which include the areas of labour practices, career development and training, and charitable giving. We will address areas for improvement during 2008.

Dow Jones Sustainability World Index		
	2006	2007
Economic factors	69%	69%
Environmental factors	85%	90%
Social factors	80%	71%



Ethics¹

Trend

The total number of formal ethics enquiries from employees decreased in 2007.

This was primarily due to a decrease in enquiries in the US.

Explanation

The higher proportion of calls to the Ethics Helpline in the US compared to the UK, relates to ongoing awareness and training of US employees regarding ethical business conduct, and to employees' of newly acquired businesses enquiries through the helpline. Enquiries on Employee Relations and Conduct and Conflicts of Interest were most frequently addressed.

UK employees also have other routes, for example, the Respect at Work process, through which to raise issues on workplace behaviour. During 2007 there were five formal investigations into Respect at Work issues. Going forward we intend to standardise the approach for employees to raise issues on ethical behaviour and conduct across our global operations.

Formal ethics enquiries from employees			
	2005	2006	2007
UK/ RoW	31	62	55
US	336	348	272
Total	367	410	327

Dismissals

For reasons relating to unethical behaviour		
	2006	2007
UK/ RoW	28	36
US	188 ⁶	224
Total	216	260

Types of calls to Ethics Helpline resulting in enquiries

	UK / RoW	US
Accounting charges practices	2	60
Company ethical practices	2	–
Conflicts of interest	3	68
Employee relations and conduct	37	79
International business issues	1	1
Procurement, trade and marketing	4	7
Quality or manufacturing issues	4	–
Scientific integrity	1	–
Security and misuse of assets	1	15
Contract compliance	–	5
Management practices	–	37
Total enquiries	55	272

Footnotes

¹ This recorded data is derived from internal systems and is not subject to external verification or audit.

⁶ This figure was reported in our 2006 report as 22 dismissals. This figure related only to dismissals resulting from employee calls to our Ethics Helpline. The total number of dismissals in the US in 2006 was 188.

Diversity¹

Trend

The proportion of female employees at BAE Systems is gradually increasing over time. In 2007, 21% of our employees were women, up by 1 percentage point from the previous year.

Explanation

We are working to change the demographics within our business but recognise that this will occur slowly over time. The sustainability of our workforce and our ability to win and fulfil global contracts depends on us being able to recruit and retain talented people from all backgrounds.

In 2007, each business developed a diversity action plan to help us move towards our goal of establishing a workforce reflective of the national average in terms of gender mix and ethnic diversity.

Our approach to diversity in each of our Home Markets is tailored to local culture and heritage. In South Africa, for example, our diversity plans are aligned with the South African Government's Black Economic Empowerment Agenda; in Saudi Arabia, we focus on increasing the number of Saudi nationals in our workforce and transferring skills to local engineers.

In 2008, we will focus on supporting women in developing their careers at BAE Systems by creating a Women's Forum and raising awareness of diversity issues among senior management. Also senior leaders are required in 2008 to undergo a Diversity Awareness Training Programme.

Diversity in the workplace 2007



50% of South African employees are non-white

53% of Saudi employees are Saudi nationals

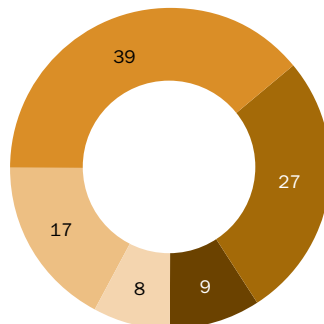
36% of employees are aged 50 and above

21% of employees are female

Employees 2007

Total **97,500**

Age diversity 2007 %



Age

- 25 years and younger
- 26-35 years
- 36-49 years
- 50-59 years
- 60 years and older

Ethnic diversity – UK, US and South Africa⁷ %

	UK	US	SA	Total
2005				
White	99	78	–	88
Non-white	1	22	–	12
2006				
White	99	77	–	87
Non-white	1	23	–	13
2007				
White	99	73	50	82
Non-white	1	27	50	18

Ethnic diversity – Kingdom of Saudi Arabia %

	2006	2007
Saudi national	52	53
White European	39	36
Asian	1	1
Other	8	10

Gender diversity⁸ %

	UK	US	AUS	Saudi	SA	Total
2005						
Male	83	73	83	99	–	81
Female	17	27	17	1	–	19
2006						
Male	86	73	83	99	–	80
Female	14	27	17	1	–	20
2007						
Male	85	71	84	99	91	79
Female	15	29	16	1	9	21

Footnotes

1 This recorded data is derived from internal systems and is not subject to external verification or audit.

7 Due to legislation in Sweden we cannot report ethnic diversity information for this country. We do not collect ethnic diversity data for our business in Australia.

8 Due to legislation in Sweden we cannot report gender diversity information for this country.

Environment¹

Environmental impacts are directly related to the stage and volume of production or manufacture and throughput of specific projects. Given the potential diversity of influences we report data as absolute values and have provided specific explanation of the variance below.

Trends

Our total energy use and related CO₂ emissions have gradually decreased since 2005. In 2007, our total energy use was down by 2.1% from the previous year, accompanied by a 3.5% reduction in emissions.

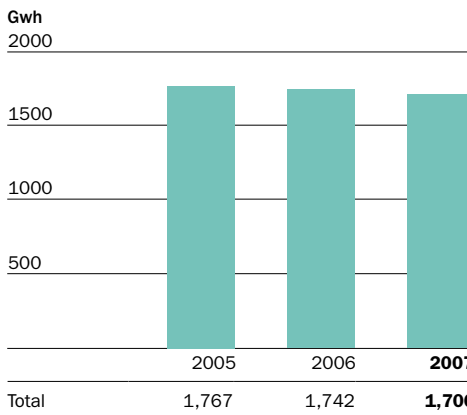
The total waste generated has increased by 23% in 2007 from 2006. 2007 saw a reduction of 13% in the volatile organic compounds released from our operations.

Explanation

Our environmental performance is reported in absolute terms and not normalised. We have cut our energy use despite business growth and increased production volume as a result of our focus on energy management and efficiency in our operations.

The increase in the total waste produced is a result of the increase in activity in our Land & Armaments business in response to requests from the US Government to support the Bradley vehicle project to reset and upgrade armoured combat vehicles.

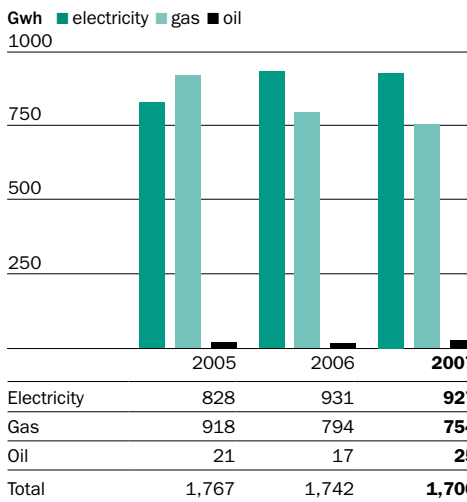
Energy use



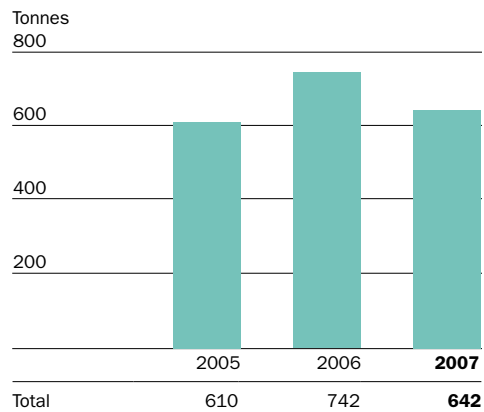
Waste⁹ and recycled waste¹⁰



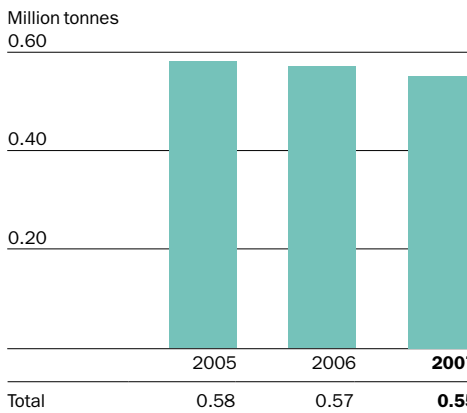
Energy use by source



Volatile organic compound emissions⁹



CO₂ emissions



Footnotes

1 This recorded data is derived from internal systems and is not subject to external verification or audit.

9 In 2007 we responded to Urgent Operation Requirements from the US Department of Defense for armoured vehicles. The resultant increase in throughput primarily impacted our Steel Products and Mobility and Protection Systems divisions in the US. This resulted in an increase in waste being generated in Steel Products and in usage of paints and solvents at Mobility and Protection Systems. The resulting emissions of Volatile Organic Compounds associated with paint and solvent use increased accordingly.

10 The increase in the level of recycled waste in 2006 related to a specific soil remediation project at Chorley in the UK.

Health and safety¹

We have developed a four-year plan for improving our safety performance (see page 20) and have set a target to reduce the number of days lost per 100,000 employees by a further 10% in 2008.

The overall performance on safety has improved over 2006. This reflects a strong performance in some businesses, notably Surface Fleet Solutions. A key focus for 2008 is to ensure a consistent improvement in safety performance across all businesses.

Trend

We reduced the total number of days lost due to work-related injuries (per 100,000 employees) by almost 14% in 2007 from the previous year. However, this significant overall improvement is not consistent across our operations. Although the rate of days lost due to work-related injuries is down by more than 43% in the UK and rest of world, it is up by 14% in the US.

Our total rate of major injuries has increased by 2%, but the overall injury rate is down by 7% from 2006. We deeply regret that we suffered a fatality in 2007, with the tragic death of one of our employees during a test flight from RAF Marham in the UK. We are fully supporting the UK Ministry of Defence Board of Inquiry into this incident.

Explanation

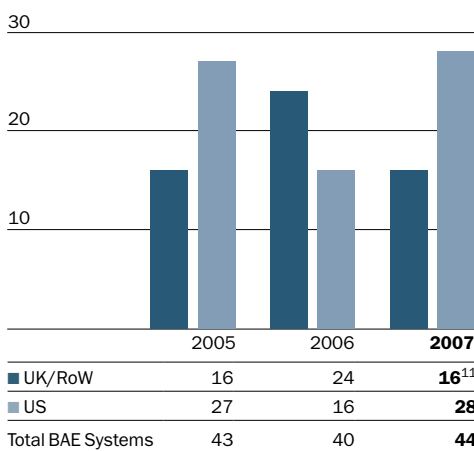
We continued to improve our overall safety performance in 2007 and reduced the number of days lost due to work-related injuries by more than our target of 10% from the previous year. Safety is one of our key CR priorities and we have implemented a number of processes and initiatives in 2007 to improve our performance in this area (see page 19).

Our Surface Fleet Solutions business based in Scotland, performed particularly well in 2007, reducing the number of days lost by 75% from the previous year. The increase in major injuries in our US businesses reflects improvements in data recording and integration of new business acquisitions into our Corporate Responsibility reporting systems.

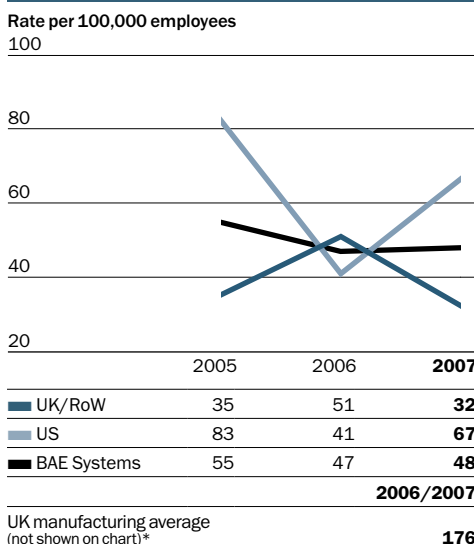
Footnotes

- This recorded data is derived from internal systems and is not subject to external verification or audit.
- Major injuries as defined under the UK Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR).
- The above data includes one fatality which occurred in 2007. This occurred during a flight testing exercise from a UK facility. The investigation into the incident is ongoing.
- Primary causes of injuries remain slips, trips and falls from same level. We continue to work on preventative measures and raising employee awareness of potential risks.
- 2011 target – 2000 days lost to work-related injuries: We have developed a four-year plan for improving our safety performance. Initial focus areas include visible senior leadership, establishing specific targets for improvement and linking safety performance to senior management bonuses. These have been incorporated into our 2008 leadership objectives (see page 5).

Major injuries recorded^{11, 12}



Major injuries recorded^{11, 12}

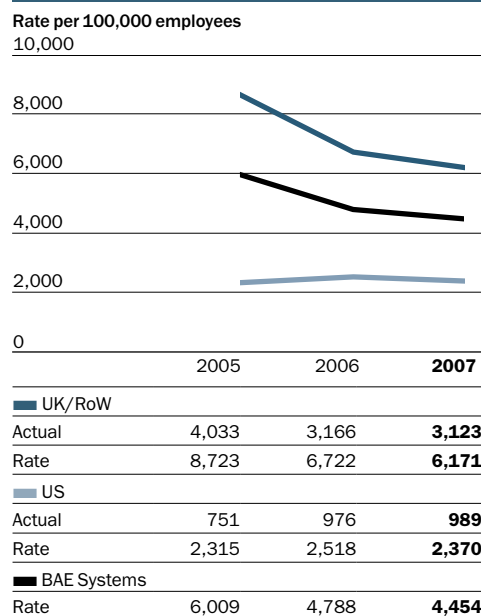


*www.hse.gov.uk

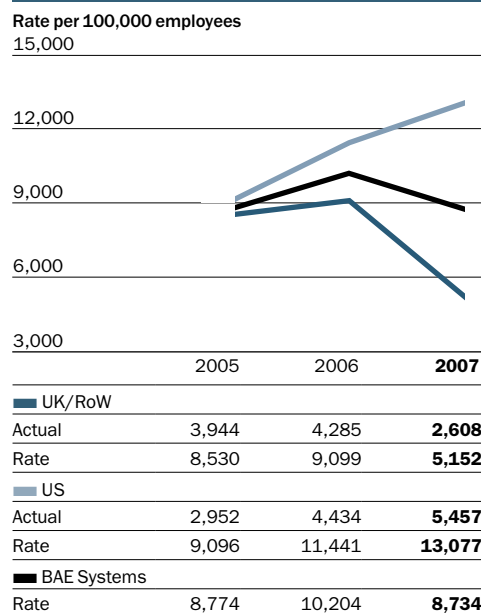
Cause of major injuries recorded 2007¹³

Cause	Number	%
Slips, trips or falls on same level	20	45.5
Fall from height of up to and including two metres	6	13.6
Struck by moving vehicle	3	6.8
Struck by moving, including flying/falling, object	3	6.8
Contact with moving machinery	2	4.6
Exposure to an explosion	2	4.6
Fall from height over two metres	2	4.6
Injured while handling, lifting or carrying	2	4.6
Strike against something fixed or stationary	2	4.6
Contact with electricity or electrical charge	1	2.0
Exposure to, or contact with, a harmful substance	1	2.3
Total	44	100.0

Total recorded injuries to all employees



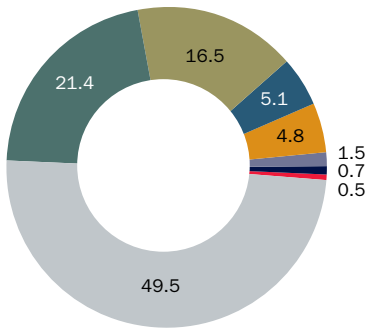
Days recorded lost to work-related injuries¹⁴



Community and education¹

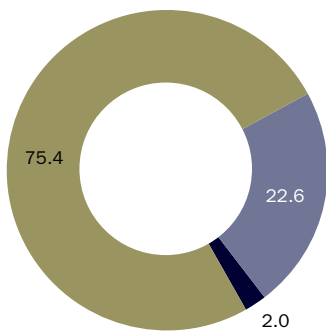
In 2007, our total community investment was approximately £6.1m. This figure includes cash and in-kind donations to charity as well as our direct support for communities and education across the world.

What we contribute to %



Area	Percentage
Arts	5.1%
Economic	0.7%
Education	21.4%
Emergency relief	1.5%
Environment	0.5%
Health	16.5%
Other	49.5%
Social welfare	4.8%

Focus of contribution %



Area	Percentage
Charitable gifts	22.6%
Community investment	75.4%
Sponsorships	2.0%

Improving education opportunities in South Africa

In South Africa, we are enabling young people to learn on the job through apprenticeships in engineering, fitting and turning, boiler-making and welding. A total of 23 students have already qualified since the programme started.

We also established an ABET (Adult Basic Education Training) programme in 2007 to help employees from disadvantaged backgrounds to improve their basic numeracy and literacy skills. On completion of the programme, participants can achieve nationally recognised qualifications.



Caring for military members injured during service

We have formed a partnership with Landstuhl Hospital Care Project, a non-profit organisation that supports members of the military who become sick or injured during service in Iraq, Kuwait and Afghanistan. The project has care facilities in Germany and field hospitals in Afghanistan and Iraq. It also donates clothing, blankets and medical supplies to military personnel in the field.



Connecting with the local community in Barrow, UK

Our UK Submarines Solutions business, based in Barrow, has established a Local Liaison Group to forge stronger links with the local community. The group – made up of Company representatives and members of local community, educational and business groups – helps us prioritise our community investment in the area. A newsletter produced by the group communicates our community activities to local residents.



Forging education links between the UK and India

In 2007, we pledged £300,000 over the next three years to support the UK India Education & Research Initiative. This UK Government initiative is designed to give students in India and the UK a better understanding of science and engineering, as well as improving education links and economic collaboration between the two countries. As part of the initiative, schools close to our site in Brough, East Yorkshire, are partners with schools in Bangalore, India, where one of our partners, Hindustan Aeronautics Ltd, is based.



Footnotes

¹ This recorded data is derived from internal systems and is not subject to external verification or audit.

we've had our say – now tell us what you think...

We welcome feedback, both positive and negative, on any aspect of our Corporate Responsibility reporting and performance. Email us at crfeedback@baesystems.com

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