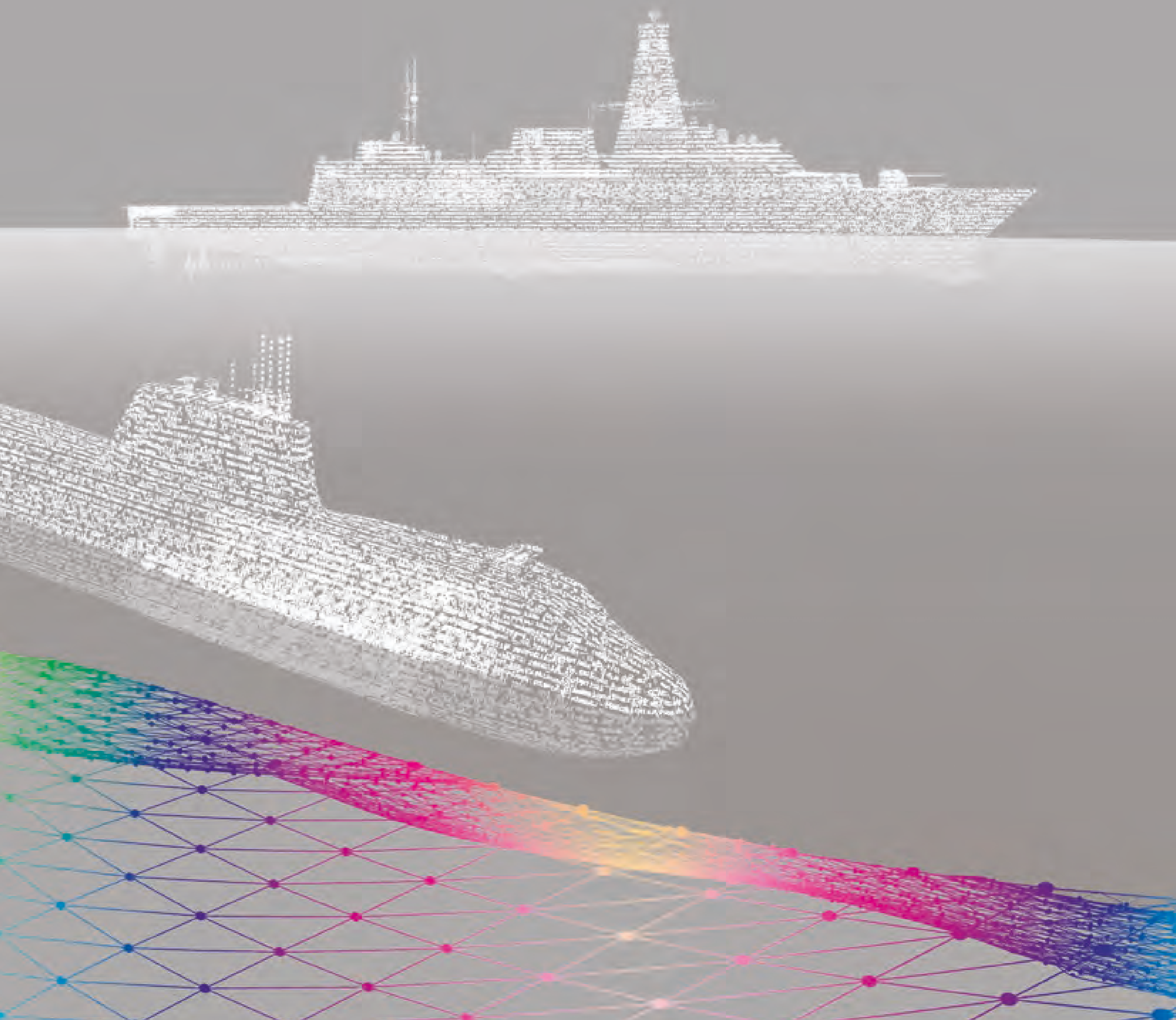
BAE SYSTEMS
INSPIRED WORK

Annual Report 2016



Welcome to the BAE Systems Annual Report 2016

Chairman's letter

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Financial highlights

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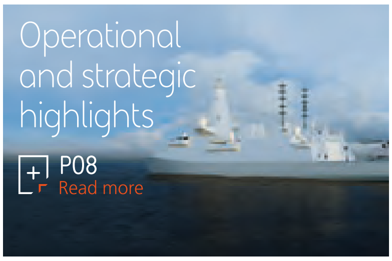

Operational and strategic highlights

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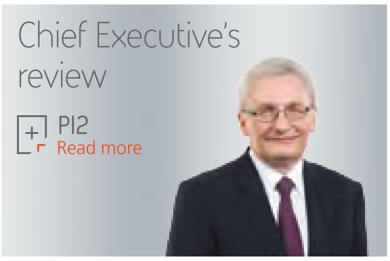

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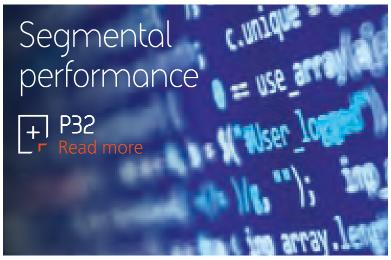

Segmental performance

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Governance highlights

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Further information can be found online by visiting **baesystems.com**

Cautionary statement: All statements other than statements of historical fact included in this document, including, without limitation, those regarding the financial condition, results, operations and businesses of BAE Systems and its strategy, plans and objectives and the markets and economies in which it operates, are forward-looking statements. Such forward-looking statements, which reflect management's assumptions made on the basis of information available to it at this time, involve known and unknown risks, uncertainties and other important factors which could cause the actual results, performance or achievements of BAE Systems or the markets and economies in which BAE Systems operates to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. BAE Systems plc and its directors accept no liability to third parties in respect of this report save as would arise under English law. Accordingly, any liability to a person who has demonstrated reliance on any untrue or misleading statement or omission shall be determined in accordance with Schedule 10A of the Financial Services and Markets Act 2000. It should be noted that Schedule 10A and Section 463 of the Companies Act 2006 contain limits on the liability of the directors of BAE Systems plc so that their liability is solely to BAE Systems plc.

Strategic report

Directors' report

Financial statements

Investor resources

Cover

The technology of defence: air, maritime, land, cyber.

At BAE Systems, our advanced defence technology protects people and national security, and keeps critical information and infrastructure secure.

We search for new ways to provide our customers with a competitive edge across the air, maritime, land and cyber domains. We employ a skilled workforce of 83,100 people[1] in over 40 countries, and work closely with local partners to support economic development by transferring knowledge, skills and technology.

1. Including share of equity accounted investments.

Our business

Sales[1] by domain

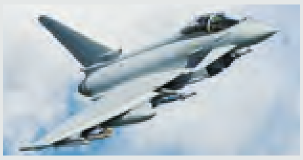
BAE Systems has strong, established positions in the air, maritime and land domains, as well as a growing position in cyber security.

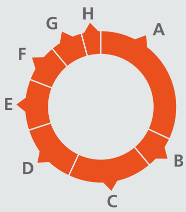
P04 Our key products and services

Air

54%

- Manufacture, development, upgrade and in-service support of Typhoon combat aircraft
- Workshare partner for the design and manufacture of major sub-assemblies and systems and provision of support for F-35 Lightning II combat aircraft
- Design, manufacture and support of avionics equipment for military aircraft
- In-service support of Tornado combat aircraft
- Design, manufacture and support of avionics equipment for commercial aircraft
- Design and manufacture of missiles and missile systems through a 37.5% interest in MBDA
- Manufacture, development, upgrade and in-service support of Hawk trainer aircraft
- Development of next-generation unmanned air systems and defence information systems



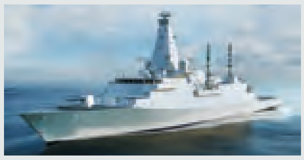


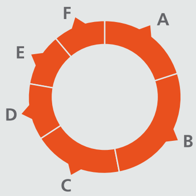
A	Typhoon	32%
B	F-35 Lightning II	7%
C	Defence avionics	18%
D	Tornado	13%
E	Commercial avionics	11%
F	Weapon systems	8%
G	Hawk	7%
H	Other	4%

Maritime

25%

- Design and manufacture of complex warships
- Design and manufacture of submarines
- Provision of ship repair and modernisation services in the US
- Provision of in-service support to surface ships and facilities management in the UK
- Design and manufacture of naval gun systems, torpedoes, radars, and naval command and combat systems



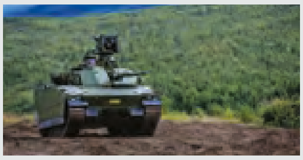


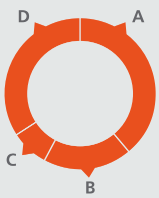
A	Complex warships	20%
B	Submarines	27%
C	US ship repair	19%
D	UK naval support	12%
E	Weapon systems	11%
F	Other	11%

Land

16%

- Design, manufacture, upgrade and support of tracked and amphibious combat vehicles
- Manufacture of ammunition and precision munitions for US, UK and other armed forces
- Design and manufacture of hybrid electric drive systems
- Design and manufacture of artillery systems and missile launchers for US, UK and other armed forces



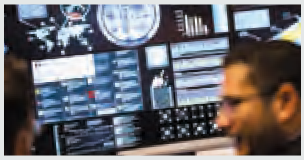


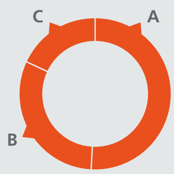
A	Combat vehicles	39%
B	Munitions	19%
C	Commercial	8%
D	Weapon systems/other	34%

Cyber

5%

- Supply of cyber, intelligence and security capabilities to US government agencies
- Supply of defence-grade cyber solutions for the commercial market
- Supply of cyber, intelligence and security capabilities to UK and other government agencies





A	US government	51%
B	Commercial	31%
C	UK and other governments	18%

2016 sales[1]

£19,020m

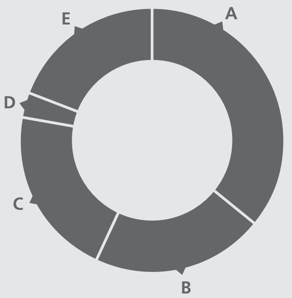
2016 revenue

£17,790m

P24
Financial review

Sales[1] by destination

BAE Systems has leading positions in its principal markets in the US, UK, Saudi Arabia and Australia.

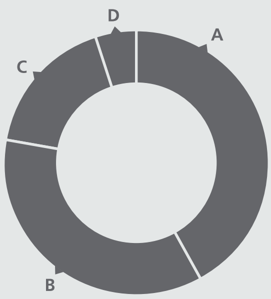


A	US	36%
B	UK	21%
C	Saudi Arabia	21%
D	Australia	3%
E	Other international markets[2]	19%

P17
Our markets

Sales[1] by activity

BAE Systems has a diverse portfolio, broadly balanced between an enduring services and support business, long-term platform and product programmes, electronic systems, and activities in cyber and intelligence.

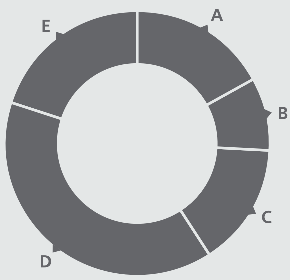


A	Military and technical services and support	42%
B	Platforms	36%
C	Electronic systems	17%
D	Cyber	5%

P32
Segmental performance

Sales[1] by reporting segment

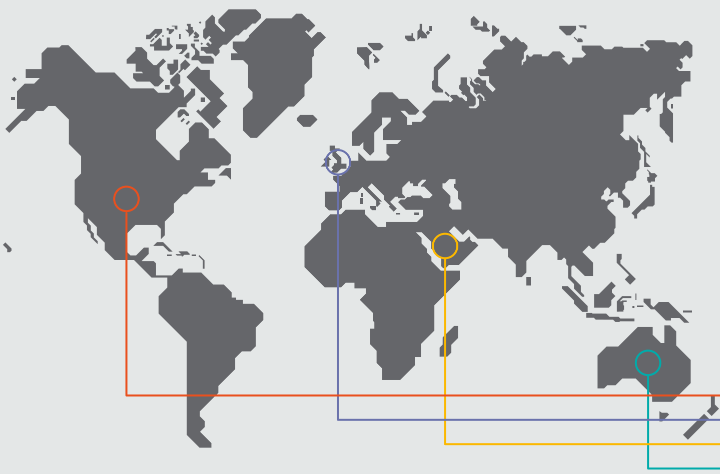
BAE Systems has five principal reporting segments which align with the strategic direction of the Group.



A	Electronic Systems	17%
B	Cyber & Intelligence	9%
C	Platforms & Services (US)	15%
D	Platforms & Services (UK)	39%
E	Platforms & Services (International)	20%

P32
Segmental performance

Employees by location



Employees[3]

83,100

P22
Our people

US	29,500
UK	34,600
Saudi Arabia	6,200
Australia	3,100
Other	9,700

1. Revenue including the Group's share of revenue of equity accounted investments.
2. Includes £1.0bn (5%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.
3. Including share of equity accounted investments.

Our key products and services

BAE Systems has strong, established positions supplying defence equipment, electronics and services, and cyber, intelligence and security solutions for governments. We also have a growing position in adjacent commercial markets, including avionics and cyber security.

Typhoon manufacture and development

Manufacture of major Typhoon assemblies for European partner nations and other export customers. Aircraft assembly for the Royal Air Force, Royal Saudi Air Force and Royal Air Force of Oman. Expansion of the capabilities of the aircraft.

F-35 Lightning II design and manufacture

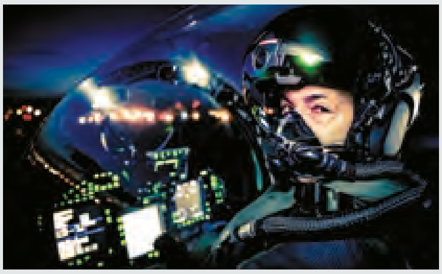
Design and manufacture of sub-assemblies, including the aft fuselage and empennage, in the UK and provision of equipment, including the electronic warfare suite, in the US. BAE Systems has a significant workshare on the world's largest defence programme.

Unmanned and future air system capabilities

Development of future air system capabilities, including unmanned air systems. A joint unmanned combat air system programme with France was announced in 2016.

Air support and training

Provision of support to operational capability. We provide maintenance, support and training for Typhoon aircraft in service with the UK and Saudi Arabian air forces. Under the Saudi British Defence Co-operation Programme, we have contracts to provide manpower, logistics and training, as well as training aircraft, including Hawk, and upgrades to Tornado aircraft in Saudi Arabia. We provide support for Hawk aircraft in service in 15 countries and have been selected to provide sustainment services for the F-35 Lightning II aircraft in the Europe and Pacific regions.



Defence avionics equipment

Design, manufacture and support of avionics equipment across a range of US and other western military aircraft programmes, including a leadership position in the electronic warfare market.

Commercial avionics equipment

Design, manufacture and support of avionics equipment across multiple commercial aircraft platforms, including engine and flight controls, and cabin and cockpit systems, together with aftermarket support services. BAE Systems is a leading supplier of engine controls, including for GE engines, and is a major supplier of flight control electronics for many Boeing and other aircraft platforms.

Complex warships

Design and manufacture of two 65,000-tonne aircraft carriers and five Offshore Patrol Vessels, and design of Type 26 frigates for the Royal Navy. The aircraft carriers are expected to complete sea trials in 2017 and 2019, respectively.

Submarines

Design and manufacture of seven Astute Class nuclear-powered attack submarines for the Royal Navy. The first three Astute Class submarines are in operational service with the Royal Navy and the remaining four boats in build. The final boat is expected to enter service towards the middle of the next decade. Design and manufacture of four Dreadnought Class nuclear-powered submarines to carry the UK's Trident ballistic missiles. Manufacture of the first Dreadnought Class boat, Dreadnought, commenced in 2016.

Ship repair and naval support

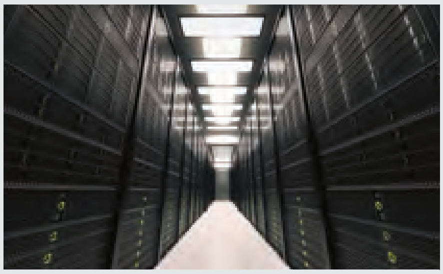
Provision of naval and commercial ship repair and modernisation services in the US, UK and Australia, together with support to the navies of the US, UK and Australia. In the US, BAE Systems has facilities located on the east, west and Gulf coasts, as well as Hawaii, and has invested in new dry dock facilities at its San Diego shipyard to support the US Navy's increased focus on Asia-Pacific operations.

Weapon systems and munitions

Design and manufacture of naval gun systems, munitions, torpedoes, radars, naval command and combat systems, artillery systems, missile launchers and, through a 37.5% interest in MBDA, missiles and missile systems. BAE Systems also manages complex ammunition plant operations for the US Army to produce insensitive munitions and propellant grains.

Combat vehicles

Products and services include: upgrade of US Army tracked vehicles, including Bradley Fighting Vehicles; design and manufacture of the US Army's M109 self-propelled howitzer and Armored Multi-Purpose Vehicle, as well as amphibious vehicles for the US Marine Corps and international customers; design, manufacture and support of the CV90 combat vehicle for international customers; and vehicle upgrade and support to the British Army.



Cyber security

Delivery of a broad range of services to enable the US military and government to recognise, manage and defeat threats. Support to UK and other government agencies in their intelligence missions. Provision of defence-grade solutions for commercial cyber applications worldwide.

Financial highlights

- Sales increased by £1.1bn to £19.0bn, almost all of which was due to exchange translation.
- Underlying EBITA increased to £1,905m, or 7% on a constant currency basis.
- Underlying earnings per share of 40.3p, 7% higher than adjusted 2015 underlying earnings per share of 37.8p[1], in line with guidance.
- Operating business cash flow increased by £323m to £1,004m.
- Net debt of £1.5bn.
- Order intake[2] increased by £7.5bn to £22.4bn.
- Order backlog[2] increased by £5.2bn to £42.0bn.

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

BONUS 80% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 87).

Financial performance measures as defined by the Group

We monitor the underlying financial performance of the Group using alternative performance measures. These measures are not defined in IFRS[3] and, therefore, are considered to be non-GAAP[4] measures. Accordingly, the relevant IFRS[3] measures are also presented where appropriate.

Sales

KPI

£19,020m

(2015 £17,904m)

Definition Revenue including the Group's share of revenue of equity accounted investments.

Purpose Allows management to monitor the sales performance of subsidiaries and equity accounted investments.

Underlying EBITA

KPI

£1,905m

(2015 £1,683m)

Definition Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items[5].

Purpose Provides a measure of operating profitability that is comparable over time.

Underlying earnings per share

BONUS KPI

40.3p

(2015 40.2p)

Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items[5].

Purpose Provides a measure of underlying performance that is comparable over time.

Operating business cash flow

KPI

£1,004m

(2015 £681m)

Definition Net cash flow from operating activities excluding taxation after net capital expenditure, financial investment and dividends from equity accounted investments.

Purpose Allows management to monitor the operating cash generation of the Group.

Net debt

BONUS KPI

£(1,542)m

(2015 £(1,422)m)

Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments).

Purpose Allows management to monitor the net cash generation of the Group.

Order intake[2]

BONUS KPI

£22,443m

(2015 £14,921m)

Definition Funded orders received from customers including the Group's share of order intake of equity accounted investments.

Purpose Allows management to monitor the order intake of subsidiaries and equity accounted investments.

Order backlog[2]

£42.0bn

(2015 £36.8bn)

Definition Funded and unfunded unexecuted customer orders including the Group's share of order backlog of equity accounted investments. Unfunded orders include the elements of US multi-year contracts for which funding has not been authorised by the customer.

Purpose Supports future years' sales performance of subsidiaries and equity accounted investments.

Financial performance measures defined in IFRS[3]

Reconciliations from the financial performance measures as defined by the Group to these measures are provided in the Financial review on pages 24 to 30.

Revenue

£17,790m
(2015 £16,787m)

Definition Income derived from the provision of goods and services by the Company and its subsidiary undertakings.

Operating profit

£1,742m
(2015 £1,502m)

Definition Profit for the year before finance costs and taxation expense. This measure includes finance costs and taxation expense of equity accounted investments.

Basic earnings per share

28.8p
(2015 29.0p)

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

Net cash flow from operating activities

£1,229m
(2015 £808m)[6]

Definition Net cash flow from operating activities in accordance with International Accounting Standard 7, Statement of Cash Flows.

- Revenue increased by £1.0bn to £17.8bn, almost all of which was due to exchange translation.
- Operating profit increased to £1,742m, or 10% on a constant currency basis.
- Basic earnings per share of 28.8p.
- Net cash flow from operating activities increased by £421m to £1,229m.

Other financial highlights

Group's share of the net pension deficit

£(6.1)bn
(2015 £(4.5)bn)

Definition Net International Accounting Standard 19, Employee Benefits, deficit excluding amounts allocated to equity accounted investments.

Dividend per share

21.3p
(2015 20.9p)

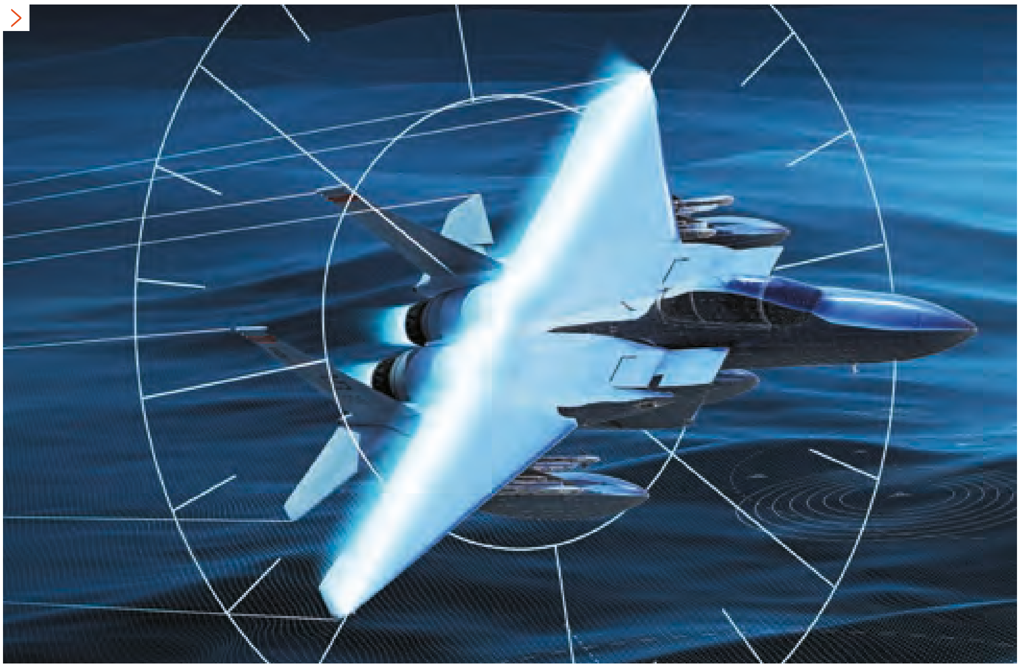
Definition Interim dividend paid and final dividend proposed per share.

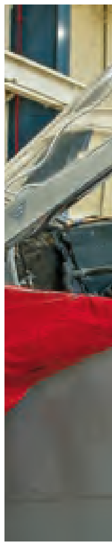
- Group's share of the pre-tax accounting net pension deficit increased by £1.6bn compared with 31 December 2015 to £6.1bn, largely unchanged from 30 June 2016.
- Final dividend of 12.7p per share making a total of 21.3p per share for the year, an increase of 2% over 2015.

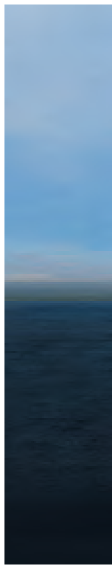
1. 2015 underlying earnings per share (40.2p) excluding tax provision releases (–4.3p) and adjusted to 2016 exchange rates (+1.9p).
2. Including share of equity accounted investments.
3. International Financial Reporting Standards.
4. Generally Accepted Accounting Principles.
5. Items that are relevant to an understanding of the Group's performance with reference to their materiality and nature (see page 25).
6. Re-presented to reclassify interest paid from operating to investing activities.

Operational and strategic highlights

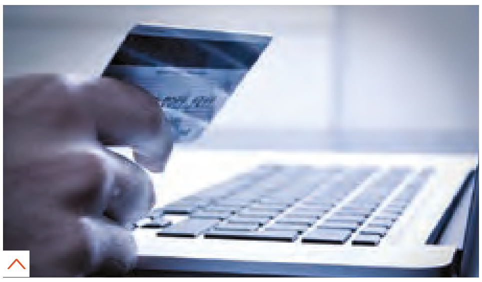
Awarded a $146m (£118m) engineering and manufacturing development contract for the US Air Force's Eagle Passive Active Warning Survivability System as a follow-on to the technology maturation and risk reduction phase.







Roll-out of the first prototype Armored Multi-Purpose Vehicle for the US Army (pictured) and delivery of the first prototype Amphibious Combat Vehicles for the US Marine Corps.



Continued growth in commercial cyber security and counter-fraud from investment in product development, and sales and marketing.

To support the US Navy's re-balance to the Asia-Pacific region, a new dry dock arrived in our San Diego shipyard in December.

P12 Chief Executive's review

P32 Segmental performance

Continued provision of support agreed under the Saudi British Defence Co-operation Programme to the Royal Saudi Air Force and Royal Saudi Naval Forces through to 2021.

In maritime in the UK, £472m extension to the Type 26 frigate demonstration phase contract, £287m contract for two additional Offshore Patrol Vessels, including support services for the five-ship programme, and £1.3bn of funding for the Dreadnought Class submarine programme, including design, initial manufacture, materials and facilities investment.

Secured a $542m (£439m) contract to provide 145 M777 lightweight howitzers to India in January 2017.

On Typhoon, partnership arrangement for support to the UK fleet expected to be worth at least £2.1bn over a ten-year period and £1.0bn of orders for BAE Systems' workshare on 28 aircraft for Kuwait.

On the F-35 combat aircraft programme, delivered the 250th electronic warfare suite in the US, received orders for additional Low-Rate Initial Production in the US and UK, and selected to provide maintenance, repair, overhaul and upgrade services to support a range of aircraft system components in the UK and Australia for the Europe and Pacific regions, respectively.

Chairman's letter

"Another year of solid performance."

Sir Roger Carr Chairman

2016 proved to be a turbulent year across the globe with unexpected changes occurring politically, economically and socially, and growing evidence of regional instability, terrorism and military aggression.

Dividend (pence)

21.3p
+2%

Against this background, governments in our major markets – primarily the UK, US, the Kingdom of Saudi Arabia and Australia – continue to prioritise national security and remain resolute in their commitment to defence expenditure.

In a period of uncertainty, the Company's consistently strong operational performance and success in growing our order backlog to £42.0bn were both reassuring and welcome.

In the UK, we secured our long-term position on a number of major programmes during 2016. Manufacturing of the Royal Navy's Dreadnought submarines at our Barrow-in-Furness facilities commenced in September. We secured a contract for two further Offshore Patrol Vessels and agreed heads of terms reflecting the government's intention to build eight Type 26 complex warships at our shipyards on the Clyde in Scotland from the summer of 2017.

These important commitments will provide the Royal Navy with state-of-the-art capabilities and reinforce our reputation as a world leader in engineering and technology. Over the next three decades, the programmes will secure high-quality employment, not only in Barrow and on the Clyde, but in the supply chain throughout the UK.

The strength of our maritime business was complemented in military air by long-term support contracts for the UK Typhoon and Hawk fleets, growth in production volumes for the F-35 Joint Strike Fighter and the selection of our UK and Australian businesses to provide avionics and components maintenance and support for the growing F-35 global fleet.

Our US land business continues to perform well in the export market and rolled out the first prototype vehicles for two major land programmes – Armored Multi-Purpose Vehicles for the US Army and Amphibious Combat Vehicles for the US Marines.

Our investment in a major new dry dock facility at our San Diego shipyard, delivered in December, will underpin our continued position as a major supplier of ship repair and support services for the US Navy.

The market for electronic warfare and products from our Electronic Systems sector remained buoyant. Our cyber, intelligence and security capabilities remain in high demand in a very competitive market. Our US-based Intelligence & Security business secured a number of multi-year contracts and, in Applied Intelligence, whilst investment in future growth inhibited current profitability, another year of double-digit sales growth across government and commercial divisions was encouraging.

The management team is aware that, as the order book grows, flawless execution remains the priority of the day. In meeting this objective and delivering customer satisfaction, we will continue to respect the growing need for high-quality local employment and support for national industry, together with a keen focus on providing leading capabilities at a competitive cost. Our experience in the Kingdom of Saudi Arabia and India in particular has provided the Company with strong and proven credentials in this area which we believe will be increasingly important in securing further orders in the coming years.

Building local capability will require the commitment of many of our people in supporting the workforce in the region and the evidence of our skill in training others is visible wherever I visit our teaching centres.

In order to ensure a consistent flow of skilled people to meet the demand, we have continued to invest in the training of both apprentices and graduates. This year, we are training over 2,000 apprentices in the UK – more than ever before.

In December, we celebrated the opening of a new £16m Academy for Skills & Knowledge adjacent to our military aircraft manufacturing facility at Samlesbury as further evidence of our commitment to building and sustaining the skills pipeline.

In addition, together with other leading engineering companies in the UK, we contributed to developing a National Productivity Improvement Plan with the creation of a formal educational productivity training programme at Lancaster University and sharing best practice with supply chain partners.

We believe that, as an international leader in engineering, advanced manufacturing and technology, we have a responsibility to ensure our Company and the nations we serve are equipped with the skills and competitive strength to succeed in global export markets.

Ensuring we have a continued supply of talent is an essential element of long-term business planning – as is the need to manage organised succession at all levels of the business. In this respect, since becoming Chairman, it has been necessary to plan for the retirement of Ian King who became Chief Executive over eight years ago.

In February 2017, we announced that Ian will retire from the Company on 30 June 2017, after a long and distinguished career of some 40 years in the defence industry. Ian will retire leaving a legacy of disciplined operational and financial performance, ethical behaviour, a burgeoning order book, a track record of delivering shareholder value and a strong leadership team. When the time comes later this year, he will leave with our thanks and best wishes for the future.

The Board also announced that Charles Woodburn, Chief Operating Officer, will succeed Ian as Chief Executive with effect from 1 July 2017. Since joining the Company in May 2016, Charles has made an important contribution, bringing impeccable engineering credentials, broad international experience and fresh perspectives to build on our existing strengths. In his new role, he will build on an enviable inheritance to create an exciting future for the Group.

During the course of the year, we aimed to build ever stronger relationships with our customers, recognising that, in the defence sector, we are partners working together to protect national interests and security. In the US, the Kingdom of Saudi Arabia and Australia, engagement with political and military leaders has been consistently constructive and positive. We continue to work closely with the UK government and have benefited from their unstinting support in our export activities. We have had considerable success in our export activities and in securing future opportunities – as seen most recently in India and Turkey.

The Kingdom of Saudi Arabia remains an important market for the Group, where we work as prime contractor to the UK government to fulfil its obligations under government-to-government agreements on defence and security co-operation. Judicial Review proceedings into the process followed by the UK government in granting defence export licences to the Kingdom of Saudi Arabia are under way, with a judgment expected in the near future.

We are aware of the privileged position we enjoy in all our markets and recognise our responsibility in driving down costs whilst maintaining the highest quality standards. In parallel with our determination to build competitive strength, we have continued to focus our people on the importance of safety in what we do and the ethics of how we do it.

In both areas we have been pleased that our record in the year has demonstrated how deeply these principles are embedded in the corporate culture as the hallmarks of good business practice. Performance-driven, but values-led remains at the heart of our business model.

In keeping with many organisations, the changing dynamics of financial markets have impacted our pension fund deficit during the year. The mathematical impact of reduced bond yields and low interest rates, partially offset by strong asset performance, has increased the reported total deficit by approximately £1.6bn during the year. Whilst the position will fluctuate in keeping with international financial markets, our large order book, long-term programmes and strong franchise positions give confidence in our long-term ability to fund our pension schemes, capital requirements and shareholder returns.

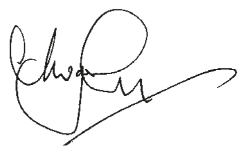
In view of the Group's good performance and future prospects, the Board has recommended a final dividend of 12.7p per share for a total of 21.3p per share for the full year, an increase of 2% compared to 2015. Subject to shareholder approval at the May 2017 Annual General Meeting, the dividend will be paid on 1 June 2017 to holders of ordinary shares registered on 21 April 2017.

We were pleased to welcome Elizabeth Corley as a non-executive director on 1 February 2016. Her appointment has further strengthened and deepened the expertise and experience of our board of directors.

In summary, we have been pleased to deliver another year of solid performance with sales[1] of £19.0bn, underlying earnings per share[1] of 40.3p underpinned by an order backlog[1] of £42.0bn. Our cash generation has continued to facilitate growth in our dividend to 21.3p whilst supporting our commitment to our pension fund and capital investment programme.

Looking forward, our efforts will be focused on the successful execution of the orders we have achieved whilst seeking to harvest the international export opportunities which lie ahead.

It is against this background that we look forward to delivering continued strong performance in 2017 and beyond.



Sir Roger Carr Chairman

P06–07
Alternative performance measure definitions

1. We monitor the underlying financial performance of the Group using alternative performance measures.

Chief Executive's review

2016 was a good year for BAE Systems. The Company has performed well despite economic and political uncertainties, delivering sales and order backlog growth. Governments in our major markets continue to prioritise defence and security with strong demand for our capabilities.

2016 performance

US

Following the two-year Bipartisan Budget Act signed in 2015, the defence market outlook in the US is improving with encouraging signs of a return to growth in defence budgets. We are also seeing the ramp up of production on a number of the Group's long-term programmes.

Our US electronics business continued to perform well, with strong programme execution and good order intake enhancing positions in the high-technology areas of electronic warfare, electro-optics and Intelligence, Surveillance and Reconnaissance. As a major supplier on the F-35 Lightning II combat aircraft programme, including the electronic warfare system, we are well positioned on the progressive increases in production output planned over the coming years to meet the requirements of US and international customers.

The Eagle Passive Active Warning Survivability System electronic warfare upgrade for US Air Force F-15 aircraft is progressing to its engineering and manufacturing development phase. The Advanced Precision Kill Weapon System (APKWS™) laser-guided rocket is experiencing growing demand and, in October, the US Navy awarded a three-year Indefinite Delivery, Indefinite Quantity contract for Full-Rate Production.

Performance in the commercial electronics business continued to be good and our all-electric and hybrid power and propulsion business delivered growth.

The Group's US-based combat vehicles business is underpinned by the Armored Multi-Purpose Vehicle and M109A7 self-propelled howitzer contracts. The business is also experiencing US and international demand on amphibious programmes.

The US land business delivered good export order intake in the period on the back of contract awards on Assault Amphibious Vehicles to Japan, BvS10 military vehicles to Austria, CV90 combat vehicle upgrades for Sweden, and M109 and M113 upgrades to Brazil, and our weapon systems business was awarded contracts for gun systems for the Royal Navy Type 26 frigate. The contract for M777 howitzers to India under a US Foreign Military Sale was signed in January 2017.

FNSS, the Turkish land systems business in which BAE Systems holds a 49% interest, secured further domestic and international orders in the year, and the business holds an order book of $1.1bn (£0.9bn).

These long-term contracts, which offer opportunities in international markets, and our strong franchise in tracked vehicles make the land business well placed for a return to growth in the medium term.

BAE Systems is a leading supplier of ship repair services to the US Navy and continues to adjust its workforce and facilities to meet evolving demand. Our San Diego operations are expected to benefit from enhanced Asia-Pacific deployment over the mid-term, mitigating the anticipated reduction in activity in the East Coast facilities. Additional dry dock capacity for the San Diego operations became operational in February 2017.

Our US business's commercial shipbuilding contracts have been challenging in the year, with further charges taken. Six ships have now been accepted and production of the remaining two is maturing well with delivery and customer acceptance expected in 2017. The US business has not contracted for any more commercial ship-build.

Whilst market conditions remain highly competitive and continue to evolve, our US-based Intelligence & Security business has performed well, securing good 2016 order intake including a number of new multi-year service contracts.

Our strategy in action
Drive value and growth from our defence platforms and services

F-35 Lightning II global sustainment

We are a key partner in the development, manufacture, integration and sustainment of F-35 Lightning II, the world's largest defence programme. In 2016, we cemented our position as part of the emerging global sustainment network to support the aircraft.

In the US, we are the Electronic Warfare, Vehicle Management Computer and Active Inceptor System provider. In addition, we are part of the Integrated Test Force team, providing support activities, including fleet management, maintenance, repair and overhaul, spares, software development and support, and training.

In the UK, we will carry out maintenance and upgrade services for avionics and aircraft components, alongside our partners, as a European repair hub. We are also delivering engineering, management and training facilities in preparation for the arrival of the aircraft in the UK.

In Australia, we will be responsible for airframe maintenance, repair, overhaul and upgrade in the South Pacific for F-35 Lightning II aircraft operating in the region from 2018. We will also provide maintenance, repair, overhaul and upgrade services for F-35 avionics and aircraft components working alongside our industry partners.

More online
baesystems.com

UK

Our UK-based business continued to perform well, benefiting from good programme execution and stability in customer requirements following the UK Strategic Defence and Security Review in 2015.

Whilst the result of the 2016 EU referendum in the UK continues to create economic uncertainty, good progress has been achieved in implementing the Strategic Defence and Security Review through long-term contract awards and commitments.

In the air domain, Typhoon aircraft deliveries for the Royal Air Force and Royal Saudi Air Force continued alongside airframe sub-assembly deliveries to European partner nations. The Oman Typhoon programme is on track to commence deliveries in 2017. The contract to supply 28 Typhoon aircraft sets for the Kuwaiti Air Force is consistent with the medium-term production planning assumptions announced last year. We have received £1bn of order intake on this programme.

Export activity continues to be well supported by the UK government and, although there can be no certainty as to the timing of orders, discussions with current and prospective operators of the Typhoon aircraft continue to support the Group's expectations for additional Typhoon contract awards.

Typhoon's capabilities continue to expand, with the ongoing integration of the Captor E-Scan radar, Storm Shadow, Meteor and Brimstone 2 missiles, and development towards the Royal Air Force Centurion standard. A Typhoon support partnership arrangement, expected to be worth at least £2.1bn over a ten-year period, was signed in July.

UK-based production of rear fuselage assemblies for the F-35 Lightning II aircraft is increasing at the Group's advanced manufacturing facilities with much of the production investment already in place to achieve the higher production volumes.

In November, the F-35 Joint Programme Office announced that it had chosen the UK and Australia as significant repair hubs for the maintenance, repair, overhaul and upgrade of F-35 Lightning II avionics and components. These repair hub assignments will support the growing global fleet until 2025 after which the UK and Australia will undertake repairs for the European and Pacific fleets, respectively. BAE Systems plays a leading role in both the UK and Australia as we bring our strong track record of working alongside our international customers and industry partners to deliver innovative and cost-effective sustainment solutions.

Chief Executive's review continued

A long-term Hawk support contract in the UK was announced in the year and support was maintained to the Indian Hawk programme with the supply of materiel and engineering services.

The unmanned air systems activity benefited from the announcement by the UK and French governments of a new €2bn (£1.7bn) project to build unmanned combat air system demonstrators following a successful joint feasibility study.

In Turkey, following a pre-contract study phase between BAE Systems and Turkish Aerospace Industries, we have signed a heads of agreement to collaborate on the first design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force. When on contract, this will have a value in excess of £100m.

In the maritime domain, submarine activity is increasing with the Astute and Dreadnought Class submarines now both in production. The first three Astute Class submarines are in operational service with the Royal Navy and the remaining four boats in build.

The UK government's commitment to the Dreadnought programme was endorsed by Parliament during the year. Funding was received for the continued design, initial manufacture of the first boat, material commitment and facilities investment for the major redevelopment of the Barrow site.

The Ministry of Defence, BAE Systems and Rolls-Royce have signed a heads of terms to set up a Dreadnought Build Alliance documenting the UK government and industry's commitment to the delivery of the Dreadnought Class submarine programme, the replacement for the Royal Navy's Vanguard Class submarine fleet, and setting out an organisational and managerial structure and series of commercial principles necessary to deliver it.

The Queen Elizabeth Class aircraft carrier programme progresses with assembly of the second ship well under way. Preparations for sea trials on the first of class vessel in 2017 are maturing and activity to support entry into service is expanding.

In preparation for the manufacturing phase, an extension to the Type 26 frigate demonstration phase contract was secured in March and, under a heads of terms signed in November, BAE Systems and the Ministry of Defence reached agreement on the intention to build eight Type 26 ships on the Clyde, with a cut-steel date in summer 2017. Two additional River Class Offshore Patrol Vessels were also contracted for in December. Build of the first three Offshore Patrol Vessels is progressing well, with sea trials for the first ship planned in the second quarter of 2017.

Our strategy in action
Continuously improve efficiency and competitiveness

Dreadnought Class submarine production

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BAE Systems has entered into a heads of terms with the UK Ministry of Defence and Rolls-Royce to develop an alliance to deliver the UK's four new ballistic missile-carrying submarines. Such an alliance structure would draw on best practice between government and industry, with the aim of driving continuous improvement, efficiencies and programme performance.

Following £1.3bn of funding from the UK government, we started production on the first Dreadnought Class submarine, Dreadnought, in September. The programme already employs more than 2,600 people across the Ministry of Defence and industry, including 1,800 at BAE Systems, and to date we have worked with more than 100 suppliers, with 85% based in the UK.

International
In the 50th year of its presence in Saudi Arabia, BAE Systems continues to address current and potential new requirements as part of the long-standing agreements between the UK government and the Kingdom. Our In-Kingdom Industrial Participation programme also continues apace.

An agreement has been reached with the Saudi Arabian government for BAE Systems to continue to provide support services to the Royal Saudi Air Force and Royal Saudi Naval Forces under the Saudi British Defence Co-operation Programme for a further five years.

On the Salam Typhoon programme, the remaining four of the contracted 72 aircraft will be delivered in 2017. Deliveries have commenced under the Hawk aircraft contract signed in 2012. The Royal Saudi Air Force has achieved high utilisation and aircraft availability across its Typhoon, Tornado and training aircraft fleets.

In Australia, the business is stable. The rationalisation of the Williamstown shipbuilding facility and cost-reduction actions taken across the wider business in 2015 are complete. Long-term sustainment and upgrade contracts were received for the Anzac Class frigates and F-35 Lightning II aircraft.

In India, BAE Systems has a long-standing relationship with Hindustan Aeronautics Limited (HAL). Delivery of the second batch of HAL-built Hawk aircraft was completed in the year and an order for a further batch from the Indian Air Force is being negotiated.

In November, the US and Indian governments signed a Letter of Agreement for the Foreign Military Sale of 145 M777 lightweight howitzers and, in January 2017, we received the $542m (£439m) contract from the US government to supply these howitzers to the Indian Army. As previously announced, Mahindra & Mahindra will be our supplier to establish an assembly, integration and test facility in India as further support for the 'Make in India' initiative.

The MBDA joint venture won significant order intake on air, maritime and land platforms in the year, including a number of contracts supporting the UK's complex weapons requirements and significant export awards. Building on its already large order book, good growth in MBDA is expected over the medium term.

Cyber security

Applied Intelligence achieved double-digit order intake and sales growth. Ongoing investment in engineering capabilities, product development and marketing costs, all expensed, continues to support the future growth profile for the business.

Cyber security is becoming an important part of government security and a core element of stewardship for commercial enterprises.

Balance sheet and capital allocation

The Group's balance sheet is managed conservatively in line with its policy to retain its investment grade credit rating and to ensure operating flexibility. Consistent with this approach, the Group expects to continue to meet its pension obligations, invest in research and technology and other organic investment opportunities, and plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Investment in value-enhancing acquisitions will be considered where market conditions are right and where they deliver on the Group's strategy.

Pension schemes

The Group's share of the pre-tax accounting net pension deficit has increased by £1.6bn from 31 December 2015 to £6.1bn mainly reflecting an increase in liabilities due to a 1.2 percentage point reduction in the real discount rate to –0.5% in the UK, partly offset by returns on scheme assets.

The next UK triennial funding reviews will commence in April 2017 and, in conjunction with the trustees of the schemes and other stakeholders, the Group will be looking at various options with a focus on the longer-term view.

Responsible business

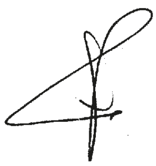
We continue to build a culture where our senior leaders and employees are empowered to make the right decisions and to know where to go for help. During 2016, we rolled out further ethics training across the Group to support employees.

The safety of our employees, and anybody who works on, or visits, our sites, remains a key priority. We provide training and tools to employees to help them understand the importance of a safe workplace. There was a 21% reduction in the Recordable Accident Rate in 2016, representing an improvement against target. In addition, there was a 26% reduction in the total number of major injuries recorded in the year as we continued to focus on reducing risk and embedding safety culture to drive improvement.

Attracting and retaining talented employees helps us to sustain our competitive edge. We encourage our employees to reach their full potential within a diverse and inclusive work environment. We have programmes in place across the business to support strategic workforce planning, career development and retention, as well as to improve diversity and inclusion.

Summary

Our business benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia. Our clear and well-defined strategy has guided us through a period of difficult market conditions. As the overall business environment in our major markets improves and through execution of our strategy, we are well placed to maximise opportunities, deal with the challenges and continue to generate attractive shareholder returns.



Ian King Chief Executive

P16
Group strategic framework

Group strategic framework

Our strategy sets out what we aim to achieve as a company.

To achieve our vision and mission, our strategy comprises five longer-term focus areas and six near-term objectives. This strategy remains consistent, with just two small changes that reflect an increasing opportunity for growth.

To maintain our world-class capabilities and seize opportunities for growth, we need to retain and recruit skilled people from the widest possible talent pool and create an inclusive culture where everyone can achieve their full potential. This is reflected in our commitment to 'inspire and develop a diverse workforce to drive success'.

With recent commitments to long-term defence platforms and support programmes and improved prospects for many of our core franchises, we have highlighted the opportunity for growth in our strategic objective to 'drive value and growth from our defence platforms and services'.

Our vision is to be the premier international defence, aerospace and security company

Our mission is to safeguard and enhance our customers' vital interests and deliver sustainable growth in shareholder value

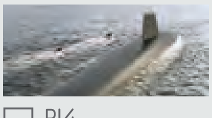
Our strategy

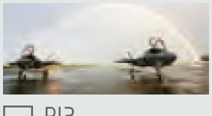
– Maintain and grow our defence businesses
– Continue to grow our business in adjacent markets
– Develop and expand our international business
– Inspire and develop a diverse workforce to drive success
– Enhance overall financial performance and competitive positions

Strategic objectives

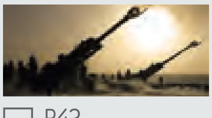
Continuously improve efficiency and competitiveness	Drive value and growth from our defence platforms and services	Accelerate the growth of our cyber, intelligence and security business	Continue to win new international orders	Continue to grow our electronic systems business	Leverage our technology and engineering capabilities

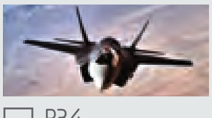
Our strategy in action

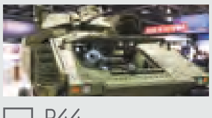

P14 Dreadnought Class submarine production


P13 F-35 Lightning II global sustainment

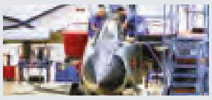

P38 Strategic alliances to drive cyber growth


P42 Expanding our international footprint


P34 Increasing production of electronic warfare systems


P44 Next-generation Bradley focuses on the future

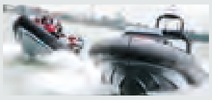

P46 UK Typhoon support contract


P50 Supporting industrialisation in Saudi Arabia


P40 International cyber defence partnering


P52 Australian Hawk support contract


P36 Growing demand for APKWS™ laser-guided rockets


P48 Developing unmanned boat technology

Our values are Trusted, Innovative and Bold

Our markets

BAE Systems is the third largest global defence company.

Supporting our customers

Our strategy focuses on developing our core franchises in defence platforms and services to support customers in our principal markets – the US, UK, Kingdom of Saudi Arabia and Australia. These are countries that are recognised as having a continued and sustained commitment to defence and security, and where we have established long-term customer relationships. We play a key role in these markets and are recognised as being a significant contributor to their defence industrial capabilities.

We have a strong position in the US through our Special Security Agreement and, as the largest defence contractor in the UK, we have a unique position amongst defence players. Our US and UK capabilities provide us with the ability to leverage intellectual property and capabilities that support our international export growth.

As markets and customer requirements develop, BAE Systems has evolved its strategy recognising the importance of cyber as an area that is rapidly becoming a priority for governments and commercial organisations alike. Cyber is now recognised as a new domain in its own right alongside the traditional military domains of air, maritime and land. Our solutions and services recognise that cyber has no borders and requires an international capability to support our government and commercial customers across the globe.

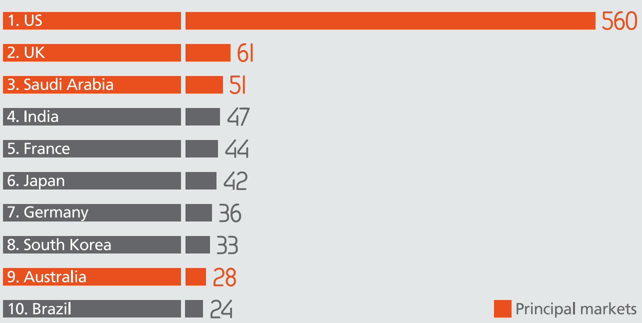
International growth aspirations

Following a number of years of defence spend contraction, global defence markets are beginning to stabilise, with a number of nations returning to growth in response to an increasingly uncertain security environment.

As the changing future character of conflict continues to shape our customers' requirements, we are responding to their needs for greater focus on technological advancements and greater agility. Our international footprint and capabilities provide us with the ability to deliver new solutions and services across geographical borders and across domains, as demonstrated in key programmes such as F-35 Lightning II sustainment.

Accessible global defence markets[1]

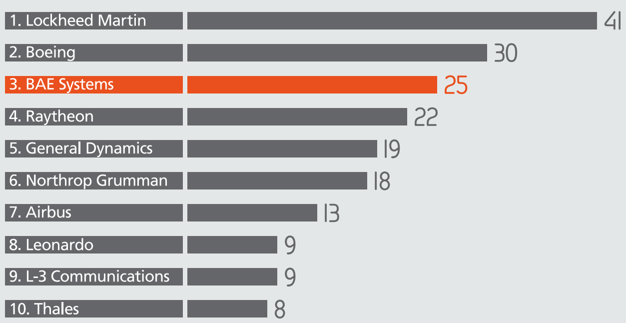
Top ten global defence markets accessible for business by the Group ($bn)



Source: 2015 US budget as shown in the Department of Defense Fiscal Year 2017 Budget Request and, outside the US, IHS Jane's Defence Budgets (based on 2015 total defence budgets and constant 2016 US dollars).

BAE Systems' global defence market position

Top ten global defence contractors' revenue ($bn)



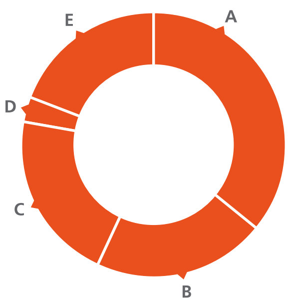
Source: Defense News Top 100 for 2016 (based on 2015 numbers). Exchange rate applied to BAE Systems is $1.41/£1.

1. Markets inaccessible for business by BAE Systems are excluded.

Our markets
continued

BAE Systems has leading positions in its four principal markets and new business prospects in a number of other international markets.

Sales[1] by destination



A	US	36%
B	UK	21%
C	Saudi Arabia	21%
D	Australia	3%
E	Other international markets[2]	19%

1. Revenue including the Group's share of revenue of equity accounted investments.
2. Includes £1.0bn (5%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

US

BAE Systems remains a top ten defence supplier in the US.

We provide products and services that span the air, maritime, land and cyber domains through our Electronic Systems, Intelligence & Security and Platforms & Services (US) businesses.

Whilst budgetary pressures are expected to continue in the US, it remains the single largest defence market in the world by some margin.

Operating under a Continuing Resolution through the spring of 2017, defence spending is expected to stay at levels above the Budget Control Act caps through the September close of the 2017 fiscal year, with potential upside if the new administration is able to secure additional Department of Defense budget and appropriations legislation to support President Trump's campaign promises to build up the US military.

The US-based business has strong, long-standing market positions and capabilities in electronic warfare systems, advanced avionics, precision-guided munitions, next-generation IT and intelligence analysis, combat vehicles, naval guns, and naval ship repair and modernisation services.

In addition to our position on some of the premier defence programmes in the US, a significant portion of the US-based portfolio is focused on Foreign Military Sales and direct international sales opportunities to key allied nations. These activities and pursuits include avionics, engine and flight controls, and cabin systems for the commercial aviation market, electric drive propulsion systems in the international bus transit market and export sales, such as those for defence electronics, combat and amphibious vehicles and, most recently, the M777 lightweight howitzer.

UK

BAE Systems is the largest defence company in the UK, with strong and enduring relationships with the Ministry of Defence.

We hold key positions in providing equipment and services to the UK armed forces across air, maritime, land and cyber. In turn, the UK government plays a crucial role in supporting our export ambitions, recognising the benefit exports can bring to the UK economy.

The 2015 Strategic Defence and Security Review set out the UK's strategic ambitions. The subsequent Spending Review in 2015 outlined a 3.1% real-term increase to the defence budget by 2020 as part of the commitment to spend 2% of Gross Domestic Product on defence. The government has taken substantial steps in 2016 towards these plans, with the commitment to eight Type 26 frigates, a contract awarded for two additional Offshore Patrol Vessels and parliamentary approval given to maintain the Continuous-At-Sea Deterrent with a new class of four submarines, named the Dreadnought Class.

Commitment has been made to the UK's cyber security capabilities, with the launch of the National Cyber Security Strategy 2016–2021. This sets out the government's plan to make Britain secure and resilient in cyberspace, with a £1.9bn investment over the next five years.

International

Saudi Arabia

The Kingdom of Saudi Arabia is the third largest accessible defence market globally as ongoing regional challenges continue to drive a strong defence agenda.

Saudi Arabia's Vision 2030, launched in April, to diversify revenues away from oil, identifies the defence industry as an area for reform to build Saudi Arabia's industrial capability through direct investments and strategic partnerships.

Through the reorganisation of the Group's portfolio of interests in a number of industrial companies, we continue to support the Saudi National Objectives, identified in the Saudi government's Vision 2030, of local skills and technology development, increasing employment, and developing an indigenous defence industry.

We remain the prime contractor for the Saudi British Defence Co-operation Programme and the Salam Typhoon programme between the Saudi and UK governments in support of defence platforms and training systems for the Royal Saudi Air Force and Royal Saudi Naval Forces. These programmes commit us to support the Saudi National Objectives through strong, enduring partnerships providing significant collaboration and transfer of expertise to Saudi industry and the Kingdom's nationals.

Australia

BAE Systems remains the largest defence company in Australia, with activities across air, maritime, land and cyber.

Continued regional instability in the Asia-Pacific region is focusing the Australian government on strengthening and modernising its armed forces. Re-commitment to meeting the defence funding target of 2% by 2020/21 was outlined in the Australian Defence White Paper and Integrated Investment Plan during 2016. The Defence White Paper also outlined the Australian government's continued commitment to shipbuilding and support in Australia, a key sector for BAE Systems.

We remain well positioned to support government plans through participation in key programmes across air, maritime, land and cyber domains that currently include programmes such as Hawk Lead-In Fighter sustainment and Anzac frigate support and upgrade.

Other international markets

Outside of our principal markets, we have many long-standing and well-established relationships.

We have customers in more than 100 countries. Our international activities include the majority of the Group's products and services portfolio, from combat aircraft to armoured vehicles and from electronic systems to cyber security.

As growth in international defence spending in regions such as Asia and the Middle East grows faster than the more mature markets of the US and UK, we have built strong local relationships working both directly with governments and partnering with local industry.

We continue to build on our relationship with Oman, with Typhoon and Hawk deliveries due to begin in 2017 and, in India, we are building on our strong relationship with Hindustan Aeronautics Limited and a more recent relationship with Mahindra & Mahindra.

Our footprint is growing in Turkey in the tracked and wheeled armoured combat vehicles market through our joint venture with FNSS. We are also collaborating with Turkish Aerospace Industries on the first design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force.

We have a strong presence in Sweden through our BAE Systems Hägglunds tracked vehicle business and our weapon systems business.

We continue to develop our export business, including sales of Assault Amphibious Vehicles to the Japanese Ministry of Defence and, in Brazil, we are developing our presence as supported by a contract for 32 upgraded M109A5+ self-propelled howitzers awarded in September.

Through our shareholding in MBDA, our position in the missiles and missile systems market continues to grow in European and other international markets.

How our business works

We provide advanced technology defence, aerospace and security solutions that aim to give our customers a competitive edge.

We aim to deliver…

…products and services that safeguard and enhance our customers' vital interests:

Our largest customers are governments, but we also sell to large prime contractors and commercial businesses. We take on and solve some of our customers' most complex and challenging engineering and technology projects to give them a competitive edge, helping them protect what matters most.

P04

…sustainable growth in shareholder value:

Our balance sheet is managed conservatively in line with our capital allocation policy to enable us to retain our investment grade credit rating and to ensure operating flexibility.

P29

We create value through…

- Established positions on long-term programmes
- Strong relationships with governments and large commercial customers
- Our position as a trusted supplier allows us to identify emerging trends and opportunities for growth

…identifying customer needs

…services, sustainment and upgrade

- Understanding our customers to provide services that add value
- Technical expertise acquired through product design and development
- Flexibility and responsiveness to maximise availability of our customers' products

Our business model is underpinned by…

…our values

Our values of Trusted, Innovative and Bold are at the heart of everything we do. We ask all of our employees to demonstrate these values in their day-to-day work, wherever they are in the world.

P16

…our people

We have a diverse range of talented people. We invest in education and training for our existing workforce, including apprenticeship and graduate programmes, and work with education sectors to help shape the workforce of the future.

P22

...research and development

- Technological capabilities which drive innovation
- Partnerships with small and medium-sized enterprises and academia to develop new solutions
- Early-stage research which is self-funded and then further developed with customer funding

...bidding and contracting

- Critical skills in identifying risk, whilst focusing on value for customers
- Record of delivery on complex projects
- Partnerships with local companies supporting economic development

...designing and developing

- Engineering expertise in developing cutting-edge products and services
- Product safety embedded in our designs to maximise safety in the construction and use of our products
- Products designed to be easily maintained and upgraded as technology evolves

...advanced manufacturing, commissioning and integration

- Investment in advanced manufacturing facilities and techniques
- Focus on operational excellence with safety as a key priority
- Management of complex projects and supply chains

...our technology

We focus on technology innovation and engineering excellence, investing in next-generation research and development programmes to deliver competitive solutions to meet our current and future customers' needs.

P23

...our responsible behaviour

We take pride in managing our operations responsibly and we require our employees to conduct business in an ethical way under our Code of Conduct to enable us to earn and maintain the trust of our stakeholders.

P55

...our governance framework

Our robust governance framework sets out the way we do business. It details our policies and processes which, together with our culture, enable us to operate in a clear, accountable and consistent way.

P66

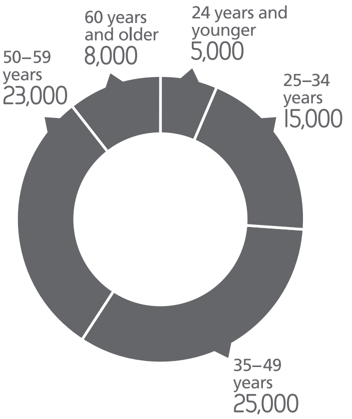
Our people

Retaining and recruiting talented people from the widest possible talent pool is a key priority.

Gender diversity

	Male	Female
Board	8	3
	73%	27%
Senior managers[1,2]	283	52
	84%	16%
Total employees[3,4]	61,000	15,000
	80%	20%

Age diversity[3,4]



1. Senior managers are defined as employees (excluding executive directors) who have responsibility for planning, directing or controlling the activities of the Group or a strategically significant part of the Group and/or who are directors of subsidiary companies.
2. Excludes executive directors.
3. Excluding share of equity accounted investments and rounded to the nearest thousand employees.
4. See summary of Deloitte LLP assurance on page 57.

Diversity

Diversity encourages creativity, drives innovation and better equips us to solve our customers' complex challenges. We are committed to creating an inclusive environment with a diverse workforce, which reflects the communities we work in.

We have programmes in place across the business to improve diversity and inclusion, including unconscious bias training, mentoring programmes, increasing female representation in senior roles and lesbian, gay, bisexual and transgender employee networks. In 2016, our Chief Executive established a global council on diversity and inclusion to progress strategic workforce planning across the business.

In 2017, we will commence gender pay gap reporting in accordance with the UK's legislative requirements, including a narrative to explain the actions we are taking to address gender diversity within our UK workforce.

Development

We want to enable every employee to reach their full potential and feel rewarded for what they do. We support this through our comprehensive career frameworks, development programmes and the breadth of our operations around the world.

In some markets, there is a shortage of qualified engineering and technology skills. We are encouraging more young people to consider careers in Science, Technology, Engineering and Mathematics (STEM) to fill this gap and support our future growth, and have a number of initiatives to support the promotion of STEM subjects and careers for young people in our markets.

Our apprenticeship and graduate programmes aim to attract top engineering talent into our business. In the UK, we are one of the biggest recruiters of apprentices and our training programme was rated 'outstanding' by the Office for Standards in Education (Ofsted). During 2016, we recruited 667 apprentices and higher-level apprentices, and 289 graduates in the UK. At 31 December 2016, we had over 2,000 apprentices in training across our UK business, 6% of the workforce.

Our focus on professional development throughout our employees' careers supports their continued personal and professional growth, and ensures that we have the skills to meet our customers' current and future requirements.

Reward

We provide our employees with competitive reward packages which reflect their individual responsibilities and contribution to business performance, and we recognise individual and team successes. Employees are offered a range of benefits, including employee share schemes, throughout their careers with the Company.

Engagement

Employee engagement enables our employees to contribute to improving business performance and helps us to gauge our performance in creating an environment in which everyone can fulfil their potential.

We keep employees informed about what is happening across the business, including Company results, major business decisions and other matters which affect them, using a variety of media, including our intranet and e-mail, through podcasts, newsletters and leadership blogs, and also through team briefs and team meetings where we seek to listen to employees' views and opinions. Employees have the opportunity to provide feedback through our engagement surveys.

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

We seek to maintain constructive relationships with our trade unions in the UK and Australia, and our labour unions in the US.

Award-winning training

Our UK apprenticeship programme was awarded the new Princess Royal Training Award in 2016 for excellence in delivering skills for business performance. The award recognises that apprentices are a key element of our talent pipeline and are given exceptional enrichment activities. Our support to young unemployed people through work experience under The Prince's Trust Movement to Work programme was also recognised and has led to many full-time roles in our business. The judges also commended our leadership in the engineering sector for our development of new standards for engineering and manufacturing apprenticeships.

Our technology

We have developed some of the world's most innovative technologies and continue to invest in research and development.

Technology

Our customers use our advanced defence technology to protect people and national security, and keep critical information and infrastructure secure. We are constantly looking to advance our technology, searching for new ways to provide our customers with a competitive edge. This can take many forms: increased protection, greater precision, superior manoeuvrability or speed, enhanced awareness of surroundings, superior range and firepower or reduced costs and greater efficiency – the ability to do more with less.

Investment

It is vital that we stay ahead of the curve. To do this, we embrace disruptive technology and we continue to drive innovation and invest in research and development both on a self-funded basis and in conjunction with our customers. Company-funded research and development investment is particularly prevalent in areas such as defence and commercial aerospace electronics, military aircraft and cyber security, and early-stage research is often further developed with customer funding.

Our research and development programmes aim to improve the capability and performance of our products and services, reduce the cost of production, and provide our customers with efficiency savings and lower through-life costs. In 2016, we spent £1.4bn (2015 £1.3bn) on research and development, of which £206m (2015 £168m) was funded by the Group.

Protecting our investment in new technologies is important and we have a portfolio of patents and patent applications covering approximately 2,000 inventions internationally.

Focus

Areas of focus include electronic warfare, platform protection, defence and commercial aerospace electronics, intelligent unmanned systems, augmented reality, cyber security and big data analytics. We also look at emergent new technologies and, in 2015, agreed to acquire a 20% interest in Reaction Engines which is working on a radical new aerospace engine concept with the potential to revolutionise hypersonic flight and the economics of space access.

Partnering

Partnerships are essential if we are to unlock the full potential of new technologies. We work closely with a range of partners, including governments, other major defence companies, small and medium-sized enterprises, and universities, bringing together the best brains to drive innovation.

Handheld cognitive electronic warfare technology[1]

Through a contract with the US Defense Advanced Research Projects Agency (DARPA), BAE Systems has developed a new lightweight handheld tactical sensor that soldiers can easily carry and use to better understand radio frequency signals for enhanced situational awareness. By using cognitive processing algorithms, this technology can quickly detect and identify multiple interfering signals, such as jammers or enemy communication signals, across a wide spectrum and in changing and challenging environments. During recent field tests, the new technology successfully detected and identified more than ten signal types across a wide bandwidth in the presence of interference. We expect to continue to mature this technology for eventual deployment within our electronic warfare, signals intelligence and tactical communications portfolios.

1. This material is based upon work supported by the US Air Force and DARPA under contract no. FA8650-11-C-7160. Any opinions, findings and conclusions or recommendations expressed in this material are those of BAE Systems and do not necessarily reflect the views of the US Air Force and DARPA.

Financial review

Peter Lynas Group Finance Director

We monitor the underlying financial performance of the Group using the alternative performance measures defined on page 6. These measures are not defined in IFRS[1] and, therefore, are considered to be non-GAAP[2] measures. Accordingly, the relevant IFRS[1] measures are also presented where appropriate.

Financial performance

Measures as defined by the Group			Measures defined in IFRS[1]
Sales: £19,020m (2015 £17,904m)	KPI	P25	Revenue: £17,790m (2015 £16,787m)
Underlying EBITA: £1,905m (2015 £1,683m)	KPI	P25	Operating profit: £1,742m (2015 £1,502m)
Underlying earnings per share: 40.3p (2015 40.2p)	KPI, BONUS	P26	Basic earnings per share: 28.8p (2015 29.0p)
Operating business cash flow: £1,004m (2015 £681m)	KPI	P26	Net cash flow from operating activities: £1,229m (2015 £808m)[4]
Net debt: £(1,542)m (2015 £(1,422)m)	KPI, BONUS	P28	
Order intake[3]: £22,443m (2015 £14,921m)	KPI, BONUS	P27	
Order backlog[3]: £42.0bn (2015 £36.8bn)		P27	

BONUS 80% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 87).

P06–07 Alternative performance measure definitions

Income statement

Sales increased by £1.1bn to £19.0bn (2015 £17.9bn), almost all of which was due to exchange translation.

Underlying EBITA increased by £222m to £1,905m (2015 £1,683m), giving a return on sales of 10.0% (2015 9.4%). There was an exchange translation benefit of £96m. Growth on a constant currency basis was at 7%.

Revenue increased by £1.0bn to £17.8bn (2015 £16.8bn).

Operating profit increased by £240m to £1,742m (2015 £1,502m), giving a return on revenue of 9.8% (2015 8.9%). There was an exchange translation benefit of £86m.

Non-recurring items represents an impairment in respect of the BAE Systems San Francisco Ship Repair business sold in January 2017. Non-recurring items in 2015 of £26m included research and development expenditure credits relating to 2013 and 2014 (£50m), partly offset by a loss on the disposal of the Group's 75% shareholding in the Land Systems South Africa business (£24m).

Amortisation of intangible assets reduced to £87m (2015 £108m) due to previously acquired intangible assets now fully amortised.

Impairment of intangible assets in 2015 mainly comprised the impairment of goodwill in the US Intelligence & Security business reflecting lower business growth assumptions.

Financial expense of equity accounted investments is £28m (2015 income £3m). There was a large gain in 2015 on the translation of foreign currency assets in Air Astana.

Net finance costs were £591m (2015 £412m). The underlying interest charge, excluding pension accounting, and fair value and foreign exchange adjustments on financial instruments and investments, increased to £245m (2015 £191m) primarily reflecting interest on the bonds issued in December 2015, incremental charges relating to net present value adjustments on the discounting of long-term liability provisions and adverse exchange translation of interest charges on US dollar-denominated borrowings. Net interest expense on the Group's pension deficit was lower at £169m (2015 £192m) mainly reflecting the lower 2015 closing deficit. Fair value and foreign exchange adjustments increased to £177m (2015 £29m) on adverse exchange translation of US dollar-denominated bonds.

Taxation expense, including equity accounted investments, of £249m (2015 £171m) reflects the Group's underlying effective tax rate for the year of 21%. The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 136. The underlying effective tax rate for 2017 is expected to increase slightly from 21% to around 22%, with the final rate dependent on the geographical mix of profits.

Looking beyond 2017, the effective tax rate will depend principally on whether there are any changes in tax legislation in the Group's most significant countries of operation, the geographical mix of profits and the resolution of open issues. With the political change in the US, proposals to significantly reform the corporate tax system are being considered. The Group will actively monitor any developments and evaluate their potential impact. The Group does not expect the future rate to be materially impacted by the changes to the international tax landscape resulting from the package of measures developed under the OECD/G20 Base Erosion and Profit Shifting project and the investigations and proposals of the European Commission. However, the Group will keep these under review.

Income statement

Financial performance measures as defined by the Group		2016 £m	2015 £m
Sales	KPI	**19,020**	17,904
Underlying EBITA	KPI	**1,905**	1,683
Return on sales		**10.0%**	9.4%

Financial performance measures defined in IFRS[1]	£m	£m
Revenue	**17,790**	16,787
Operating profit	**1,742**	1,502
Return on revenue	**9.8%**	8.9%

Reconciliation of sales to revenue		£m	£m
Sales	KPI	**19,020**	17,904
Deduct Share of sales by equity accounted investments		**(2,427)**	(2,719)
Add Sales to equity accounted investments		**1,197**	1,602
Revenue		**17,790**	16,787

Reconciliation of underlying EBITA to operating profit		£m	£m
Underlying EBITA	KPI	**1,905**	1,683
Non-recurring items		**(12)**	26
Amortisation of intangible assets		**(87)**	(108)
Impairment of intangible assets		**–**	(78)
Financial (expense)/income of equity accounted investments		**(28)**	3
Taxation expense of equity accounted investments		**(36)**	(24)
Operating profit		**1,742**	1,502
Net finance costs		**(591)**	(412)
Taxation expense		**(213)**	(147)
Profit for the year		**938**	943

Sales bridge (£bn)

P128 Note 1 to the Group accounts

Exchange rates

Average	**2016**	2015
£/$	**1.354**	1.528
£/€	**1.223**	1.377
£/A$	**1.823**	2.036

Sensitivity analysis

Estimated impact on sales of a ten cent movement in the average exchange rate	£m
$	**500**
€	**60**
A$	**30**

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Including share of equity accounted investments.
4. Re-presented to reclassify interest paid from operating to investing activities.

Financial review
continued

Earnings per share

Underlying earnings per share for the year was 40.3p (2015 40.2p). The prior year included a 4.3p per share benefit from tax provision releases. The major movements in underlying earnings per share are shown in the bridge chart below.

Basic earnings per share was 28.8p (2015 29.0p).

Earnings per share

Financial performance measures as defined by the Group		2016	2015
Underlying earnings		**£1,277m**	£1,270m
Underlying earnings per share	KPI	**40.3p**	40.2p

Financial performance measures defined in IFRS[1]	2016	2015
Profit for the year attributable to equity shareholders	**£913m**	£918m
Basic earnings per share	**28.8p**	29.0p

Reconciliation of underlying earnings to profit for the year attributable to equity shareholders	£m	£m
Underlying earnings	**1,277**	1,270
Non-recurring items, post tax	**(9)**	(19)
Amortisation and impairment of intangible assets, post tax	**(69)**	(88)
Impairment of goodwill	**–**	(75)
Net interest expense on retirement benefit obligations, post tax	**(140)**	(158)
Fair value and foreign exchange adjustments on financial instruments and investments, post tax	**(146)**	(12)
Profit for the year attributable to equity shareholders	**913**	918
Non-controlling interests	**25**	25
Profit for the year	**938**	943

Underlying earnings per share bridge (p)

* 2015 underlying earnings per share excluding tax provision releases and adjusted to 2016 exchange rates.

P138 Note 7 to the Group accounts

Cash flow

Operating business cash flow was £1,004m (2015 £681m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £253m (2015 £274m).

Receipts aggregating to approximately £250m, expected in 2017 on the Omani Typhoon programme, Saudi support and MBDA's Qatar contract, were received in 2016.

Major advances received in 2012 on the Omani Typhoon and Hawk order, and the Saudi training aircraft contract, were consumed. Advances were also utilised in the year on European Typhoon production. Costs are being incurred against provisions created in previous years, primarily on the US commercial shipbuilding programmes.

Net cash flow from operating activities was £1,229m (2015 £808m).

Taxation payments increased to £187m (2015 £116m) primarily reflecting higher payments in the US due to higher US taxable profits and timing differences.

Net capital expenditure and financial investment was £450m (2015 £284m) largely reflecting lower proceeds from sale of property, plant and equipment, and investment property of £45m (2015 £136m). Purchases of property, plant and equipment, and investment property were £49m higher primarily reflecting investment in manufacturing facilities at Electronic Systems.

Dividends received from equity accounted investments of £38m (2015 £41m) is primarily receipts from MBDA and FNSS.

Net interest paid was £27m higher at £200m (2015 £173m) primarily for interest on the bonds issued in December 2015 and adverse exchange translation of interest on US dollar-denominated borrowings.

The cash inflow in respect of **acquisitions and disposals** in 2016 of £6m reflects the sale of a 4.1% shareholding in a subsidiary company in Saudi Arabia. In 2015, the net cash inflow of £16m included £21m received from the sale of the Group's 75% shareholding in the Land Systems South Africa business, less £5m paid for the acquisition of Eclipse Electronic Systems, Inc.

Equity dividends paid in 2016 represents the 2015 final (£397m) and 2016 interim (£273m) dividends.

Dividends paid to non-controlling interests reduced to £24m (2015 £40m). An increased dividend was paid in 2015 by the Group's 75%-owned South African business prior to disposal.

As a consequence of movements in US dollar and euro exchange rates, there was a **cash inflow from matured derivative financial instruments** of £480m (2015 £12m) from rolling hedges on balances with the Group's subsidiaries and equity accounted investments. The inflow as a result of hedging cash loaned internally, from the US to the UK business, partially offsets the foreign exchange translation on the Group's external US dollar-denominated borrowing (see below).

Net cash flow from loans represents repayment of a $350m (£286m) 3.5% bond at maturity in October. In 2015, BAE Systems issued $1.5bn (£971m) of bonds in the US capital market and repaid a $750m (£481m) 5.2% bond at maturity.

Foreign exchange translation, which primarily arises in respect of the Group's US dollar-denominated borrowing, is partially offset by the cash inflow from matured derivative financial instruments (see above).

1. International Financial Reporting Standards.
2. Including share of equity accounted investments.
3. Re-presented to reclassify interest paid from operating to investing activities.

Cash flow

Financial performance measures as defined by the Group		2016 £m	2015[3] £m
Operating business cash flow	KPI	1,004	681

Financial performance measures defined in IFRS[1]	£m	£m
Net cash flow from operating activities	1,229	808

Reconciliation from operating business cash flow to net cash flow from operating activities		£m	£m
Operating business cash flow	KPI	**1,004**	681
Add back Net capital expenditure and financial investment		**450**	284
Deduct Dividends received from equity accounted investments		**(38)**	(41)
Deduct Taxation		**(187)**	(116)
Net cash flow from operating activities		**1,229**	808
Net capital expenditure and financial investment		**(450)**	(284)
Dividends received from equity accounted investments		**38**	41
Net interest paid		**(200)**	(173)
Acquisitions and disposals		**6**	16
Net cash flow from investing activities		**(606)**	(400)
Net sale of own shares		**3**	1
Equity dividends paid		**(670)**	(655)
Dividends paid to non-controlling interests		**(24)**	(40)
Cash flow from matured derivative financial instruments		**480**	12
Movement in cash collateral		**32**	3
Net cash flow from loans		**(286)**	490
Net cash flow from financing activities		**(465)**	(189)
Net increase in cash and cash equivalents		**158**	219
Add back/(deduct) Net cash flow from loans		**286**	(490)
Deduct Cash classified as held for sale		**(2)**	–
Foreign exchange translation		**(621)**	(165)
Other non-cash movements		**59**	46
Increase in net debt		**(120)**	(390)
Opening net debt		**(1,422)**	(1,032)
Net debt	KPI	**(1,542)**	(1,422)

P167 and P168 Notes 23 and 24 to the Group accounts

Orders

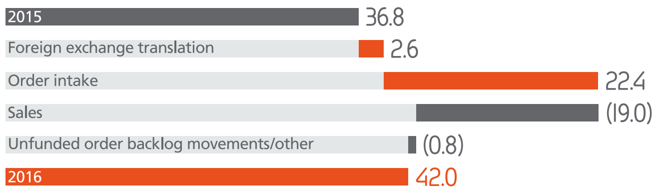
Order intake[2] increased by £7.5bn to £22,443m (2015 £14,921m). Major awards in the year included £2.1bn on the ten-year UK Typhoon support contract and initial order intake on the five-year Saudi support renewal.

Order backlog[2] increased by £5.2bn to £42.0bn (2015 £36.8bn). Exchange translation added £2.6bn compared with the prior year. The major movements in order backlog are shown in the bridge chart below.

Orders

Financial performance measures as defined by the Group		2016	2015
Order intake[2]	KPI	**£22,443m**	£14,921m
Order backlog[2]		**£42.0bn**	£36.8bn

Order backlog[2] bridge (£bn)



Financial review
continued

Balance sheet

The £1.2bn increase in **intangible assets** to £11.3bn (2015 £10.1bn) mainly reflects exchange translation.

Property, plant and equipment, and investment property increased to £2.0bn (2015 £1.8bn), including £167m of exchange translation.

Equity accounted investments and other investments increased to £305m (2015 £256m) reflecting the Group's share of profit for the year (£90m) less dividends received (£38m). Exchange translation was £52m. The increased share of pension deficit was £66m.

The £1.6bn increase in the **Group's share of the net IAS 19 pension deficit** mainly reflects an increase in liabilities due to a 1.2 percentage point decrease in the real discount rate to –0.5% in the UK, partly offset by returns on scheme assets. The major movements in the net pension deficit are shown in the bridge chart opposite.

On 1 April 2016, a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) was created, reducing the total net IAS 19, Employee Benefits, deficit, with a corresponding reduction in the allocation to equity accounted investments.

Details of the Group's pension schemes are provided in note 20 to the Group accounts on page 155.

A net deferred tax asset of £1.2bn (2015 £0.9bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

There was a £0.3bn increase in **working capital** mainly reflecting a net reduction in advance contract funding and utilisation of provisions.

The assets and liabilities of the San Francisco ship repair business sold in January 2017, both totalling £2m, are classified as **held for sale** at 31 December 2016. The Group no longer expects to complete the disposal of Aircraft Accessories and Components Company and, accordingly, has ceased classifying it as held for sale (2015 £12m).

The Group's **net debt** at 31 December 2016 is £1,542m, a net increase of £120m from the net debt position of £1,422m at the start of the year. A $350m (£286m) 3.5% bond was repaid at maturity in October. There are no further material debt maturities before 2019. The maturity of the Group's borrowings is shown in the chart opposite.

Cash and cash equivalents of £2,769m (2015 £2,537m) are held primarily for the repayment of debt securities, pension deficit funding, payment of the 2016 final dividend and management of working capital.

Critical accounting policies

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

Revenue and profit recognition	
Revenue	£17.8bn (year ended 31 December 2016) See note 1 to the Group accounts
Carrying value of intangible assets	
Intangible assets	£11.3bn (at 31 December 2016) See note 8 to the Group accounts
Valuation of retirement benefit obligations	
Group's share of the net IAS 19 pension deficit	£6.1bn (at 31 December 2016) See note 20 to the Group accounts

In addition to the critical accounting policies, management exercises judgement in applying the Group's accounting policies in respect of tax provisions and deferred tax assets.

P122–123
For more information

Balance sheet

Summarised balance sheet		2016 £m	2015 £m
Intangible assets		**11,264**	10,117
Property, plant and equipment, and investment property[1]		**1,999**	1,772
Equity accounted investments and other investments		**305**	256
Working capital[1]		**(3,564)**	(3,850)
Group's share of the net IAS 19 pension deficit (see below)		**(6,054)**	(4,501)
Net tax assets and liabilities		**935**	661
Net other financial assets and liabilities		**121**	(43)
Net debt	KPI	**(1,542)**	(1,422)
Net assets held for sale		**–**	12
Net assets		**3,464**	3,002

1. Funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme included in working capital in the Consolidated balance sheet is presented here in property, plant and equipment, and investment property.

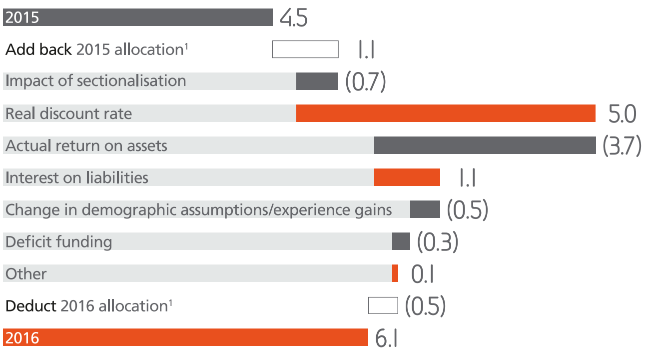
Net IAS 19 pension deficit	£m	£m
Group's share of the net IAS 19 pension deficit (see above)	**6,054**	4,501
Add back Amounts allocated to equity accounted investments	**516**	1,053
Net IAS 19 pension deficit	**6,570**	5,554

Components of net debt		£m	£m
Cash and cash equivalents		**2,769**	2,537
Debt-related derivative financial instrument assets		**114**	53
Loans – non-current		**(4,425)**	(3,775)
Loans and overdrafts – current		**–**	(237)
Net debt	KPI	**(1,542)**	(1,422)

Exchange rates

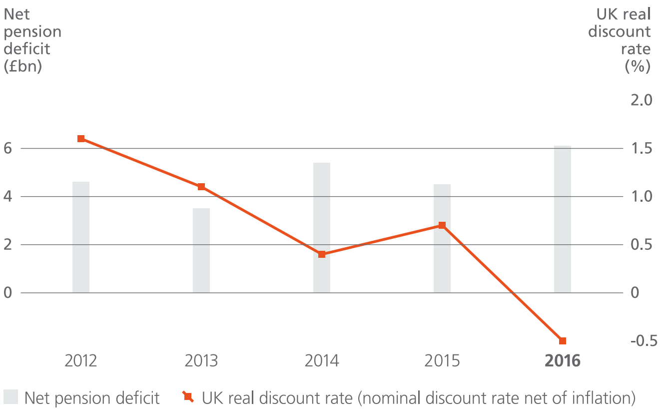
Year end	2016	2015
£/$	**1.236**	1.474
£/€	**1.172**	1.357
£/A$	**1.707**	2.027

Net pension deficit – bridge (£bn)



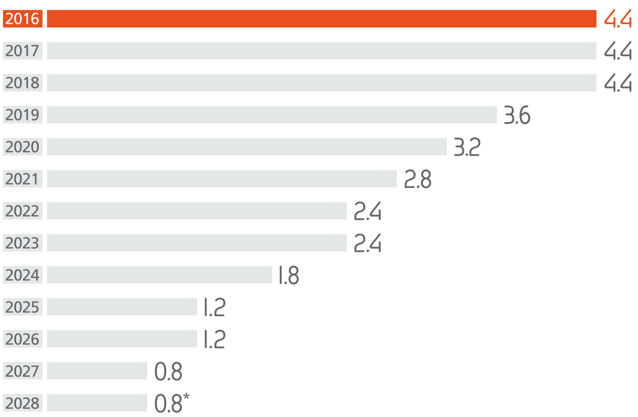
PI55 Note 20 to the Group accounts

Net pension deficit – history



PI55 Note 20 to the Group accounts

Maturity of the Group's borrowings (£bn)



*Repayable in 2041 (£320m) and 2044 (£433m).

PI53 Note 18 to the Group accounts

Capital

Objectives

Maintain the Group's investment grade credit rating and ensure operating flexibility, whilst:

- meeting its pension obligations;
- pursuing organic investment opportunities;
- paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings;
- making accelerated returns of capital to shareholders when the balance sheet allows and when the return from doing so is in excess of the Group's Weighted Average Cost of Capital; and
- investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.

Policies

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

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. Three credit rating agencies publish credit ratings for the Group:

Agency	Rating	Outlook	Category
Moody's Investors Service	Baa2	Stable	Investment grade
Standard & Poor's Ratings Services	BBB	Stable	Investment grade
Fitch Ratings	BBB	Stable	Investment grade

PI65
Note 22 to the Group accounts

Dividends

As part of the Group's capital allocation policy (see above), the Group plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings.

The Board has recommended a final dividend of 12.7p per share making a total of 21.3p per share for the year, an increase of 2% over 2015. At this level, the annual dividend is covered 1.9 times. Subject to shareholder approval at the 2017 Annual General Meeting, the dividend will be paid on 1 June 2017 to holders of ordinary shares registered on 21 April 2017. The ex-dividend date is 20 April 2017.

At 31 December 2016, the Company had retained earnings of £1.9bn (2015 £2.0bn), the non-distributable portion of which is £354m (2015 £343m) (see page 180). Total external dividends relating to 2016 are £676m (2015 £663m), including the interim dividend paid during the year of £273m (2015 £266m) and the final dividend proposed of approximately £403m (2015 £397m). On an annual basis, the Company receives dividends from its subsidiaries to increase further its distributable reserves and, accordingly, the Company expects to have sufficient distributable reserves to support its dividend policy.

The Group's dividend policy is underpinned by its viability and going concern statements (see page 71).

1. Amounts allocated to equity accounted investments.

Financial review
continued

Treasury

The Group's treasury activities are overseen by the Treasury Review Management Committee (TRMC). Two executive directors are members of the TRMC, including the Group Finance Director who chairs the Committee. The TRMC also has representatives with legal and tax expertise. The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the treasury policies approved by the Board.

Objectives/policies

Net debt

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

– Material borrowings are arranged by the central treasury department and funds raised are lent onward to operating subsidiaries as required.

Interest rates

Manage the exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, including interest rate and cross-currency swaps.

– A minimum of 50% and a maximum of 90% of gross debt is maintained at fixed interest rates.

Liquidity

Maintain adequate undrawn committed borrowing facilities.

– An undrawn committed Revolving Credit Facility of £2bn contracted to December 2018 and £1.9bn contracted from December 2018 to December 2020 is available to meet expected general corporate funding requirements.

Monitor and control counterparty credit risk and credit limit utilisation.

– The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with financial institutions with the strongest credit ratings for short periods.

Currency

Reduce the Group's exposure to transactional volatility in earnings and cash flows from movements in foreign currency exchange rates.

– All material firm transactional exposures are hedged.

– The Group does not hedge the translation effect of exchange rate movements on the income statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.

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Note 26 to the Group accounts

Tax strategy

The Group's tax strategy is to:

– ensure compliance with all applicable tax laws and regulations; and

– manage the Group's tax expense in a way that is consistent with its values and its legal obligations in all relevant jurisdictions.

The Group promotes collaborative professional working with tax authorities in order to build open, transparent and trusted relationships. As part of this, the Group engages in open and early dialogue to discuss tax planning, strategy, risks and significant transactions, and discloses any significant uncertainties in relation to tax matters. Queries and information requests by tax authorities are responded to in a timely fashion and the Group ensures that tax authorities are kept informed about how issues are progressing. The Group seeks to resolve issues in real time and before returns are filed where possible. Fair, accurate and timely disclosures are made in tax returns, reports and documents that the Group files with, or submits to, tax authorities. Where disagreements over tax arise, the Group works proactively to seek to resolve all issues by agreement (where possible) and reach reasonable solutions. In the UK, the Group is subject to an annual risk assessment by HM Revenue & Customs and strives to achieve as low a risk rating as can be achieved by a group of BAE Systems' size and complexity.

Whilst the Group aims to maximise the tax efficiency of its business transactions, it does not use structures in its tax planning that are contrary to the intentions of the relevant legislature. The Group interprets relevant tax laws in a reasonable way and ensures that transactions are structured in a way that is consistent with a relationship of co-operative compliance with tax authorities. It also actively considers the implications of any planning for the Group's wider corporate reputation.

The Group is open and transparent with regard to decision-making, governance and tax planning in its business, keeping tax authorities informed of who has responsibility, how decisions are reached, how the business is structured and where different parts of the business are located.

BAE Systems operates internationally and is subject to tax in many different jurisdictions. The Group employs professional tax managers and takes appropriate advice from reputable professional firms. The Group is routinely subject to tax audits and reviews which can take a considerable period of time to conclude. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The assessment and management of tax risks are regularly reviewed by the Audit Committee, as is the Group's tax strategy.

Arm's-length principles are applied in the pricing of all intra-group transactions of goods and services in accordance with Organisation for Economic Co-operation and Development guidelines. Where appropriate, the Group engages with governments in relation to proposed legislation and tax policy. The Group endorses the statement of tax principles issued by the Confederation of British Industry in May 2013 (www.cbi.org.uk/cbi-prod/assets/File/pdf/statement-of-tax-principles.pdf).

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Note 6 to the Group accounts

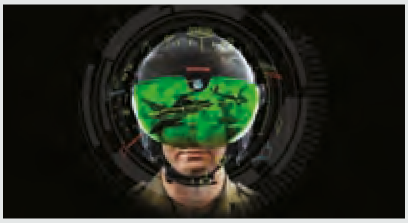
Guidance for 2017

Group guidance

For the year ending 31 December 2017, we expect the Group's underlying earnings per share to be 5% to 10% higher than full-year underlying earnings per share in 2016 of 40.3p.*

The guidance is based on the measures used to monitor the underlying financial performance of the Group. Reconciliations from these measures to the financial performance measures defined in International Financial Reporting Standards for 2016 are provided in the Financial review on pages 24 to 30.

Segmental guidance



1 Electronic Systems

- Mid single-digit sales growth is expected in 2017 driven by a number of electronic warfare contracts, with 75% of projected sales in the 2016 closing order backlog.
- Margins[1] are expected to be at the top end of a 13% to 15% range.

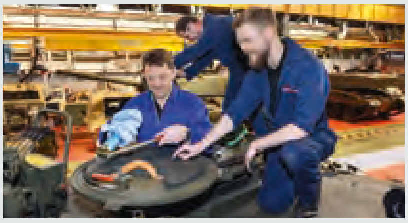
2 Cyber & Intelligence

Comprising the US Intelligence & Security sector (71% of Cyber & Intelligence sales in 2016) and Applied Intelligence:

- Low single-digit sales growth is expected in 2017, with stable sales in Intelligence & Security and double-digit growth in Applied Intelligence across each of its three divisions.
- Margins[1] are expected to improve to within a 6% to 8% range, following the high level of product development investment in the Applied Intelligence business over the last two years.

3 Platforms & Services (US)

- Sales are expected to be stable, with the completion of CV90 deliveries to Norway being offset by the increasing volumes from the US vehicles and munition businesses. Of this sales guidance, 75% is within the 2016 closing order backlog.
- Another year of margin[1] improvement, to a range of 8% to 9%, is expected in 2017, absent further charges on the commercial shipbuilding contracts.



4 Platforms & Services (UK)

- Sales are expected to be 5% lower. On Typhoon, European and Saudi deliveries are largely complete and this is only partly offset by trading on the contracts to Oman and Kuwait, along with the increased F-35 volumes. Almost 95% of this sales guidance is within the 2016 closing order backlog.
- Margins[1] are expected to be at the lower end of a 10% to 12% range, having absorbed the impact of increased pension service costs.

5 Platforms & Services (International)

- Sales growth of around 5% is expected in 2017, with increased levels of support to the Salam Typhoon aircraft and higher delivery volumes from MBDA. Close to 90% of the sales guidance is within the 2016 closing order backlog.
- Margins[1] are expected to be at a similar level to those in 2016.

6 HQ

- HQ costs are expected to be similar to those in 2016.
- Underlying finance costs are expected to be slightly lower, absent the incremental net present value charges seen in 2016.
- The underlying effective tax rate for 2017 is expected to increase slightly from 21% to around 22%, with the final rate dependent on the geographical mix of profits.

*Assuming a US$1.25 to sterling exchange rate.

1. Underlying EBITA as a percentage of sales.

P06–07
Alternative performance measure definitions

Segmental performance

We report our performance through five principal reporting segments.

Electronic Systems

P34

Cyber & Intelligence

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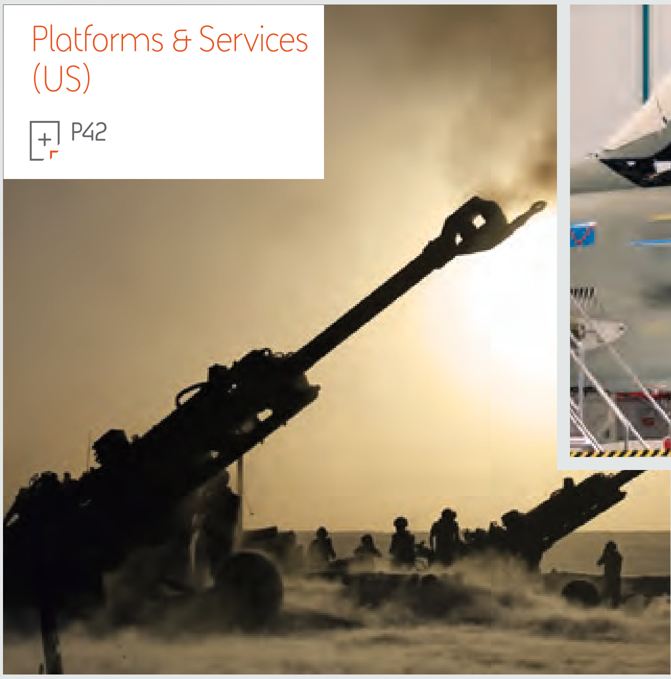
Platforms & Services (US)

P42



Platforms & Services (UK)

P46

Platforms & Services (International)

P50

Financial performance measures as defined by the Group

	KPI Sales £m	KPI Underlying EBITA £m	Return on sales %	KPI Operating business cash flow £m	KPI Order intake[2] £m	Order backlog[2] £bn	Employees[2] Number
Electronic Systems	3,282	494	15.1	469	3,322	5.2	13,800
Cyber & Intelligence	1,778	90	5.1	83	1,885	2.4	11,800
Platforms & Services (US)	2,874	211	7.3	58	3,308	4.6	11,300
Platforms & Services (UK)	7,806	810	10.4	199	8,024	17.8	30,100
Platforms & Services (International)	3,943	400	10.1	435	6,175	13.1	13,700
HQ[1]	233	(100)		(240)	226	–	2,400
Deduct Intra-group	(896)				(497)	(1.1)	
Total	**19,020**	**1,905**	**10.0**	**1,004**	**22,443**	**42.0**	**83,100**

We use these measures to monitor the underlying financial performance of the Group's reporting segments.

Financial performance measures defined in IFRS[3]

	Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m
Electronic Systems	3,282	474	14.4	568
Cyber & Intelligence	1,778	59	3.3	106
Platforms & Services (US)	2,783	182	6.5	129
Platforms & Services (UK)	7,699	780	10.1	385
Platforms & Services (International)	3,037	365	12.0	473
HQ[1]	–	(118)		(245)
Deduct Intra-group	(789)			
Deduct Taxation[4]				(187)
Total	**17,790**	**1,742**	**9.8**	**1,229**

Reconciliations from the financial performance measures as defined by the Group to these measures are provided in the Financial review on pages 24 to 30.

Reconciliations by reporting segment for revenue and operating profit are included in note 1 to the Group accounts (see page 128) and for net cash flow from operating activities in note 23 to the Group accounts (see page 167).

1. HQ comprises the Group's head office activities, together with a 49% interest in Air Astana.
2. Including share of equity accounted investments.
3. International Financial Reporting Standards.
4. Taxation is managed on a Group basis.

P06–07
Alternative performance measure definitions

Segmental performance
Electronic Systems

Electronic Systems, with 13,800 employees[1], comprises the US and UK-based electronics activities, including electronic warfare systems, electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.

Electronic Combat includes the Electronic Protection, Electronic Warfare and Electronic Attack product lines, and provides a depth of capability in integrated electromagnetic systems for airborne applications, mission planning and battle management solutions, secure networked communications and navigation systems, radio frequency communication and data links.

Survivability, Targeting & Sensing exploits the electro-optical and infrared spectrum to provide leading threat warning and infrared countermeasures systems, precision guidance and seeker solutions, advanced targeting solutions, head-up displays and state-of-the-art tactical imaging systems.

Intelligence, Surveillance & Reconnaissance addresses the market for actionable intelligence through innovative technical solutions for airborne persistent surveillance, identification systems, signals intelligence, underwater and surface warfare solutions, and space products.

Controls & Avionics addresses the military and commercial aircraft electronics markets, including fly-by-wire flight controls, full authority digital engine controls, flight deck systems, cabin management systems and mission computers.

Power & Propulsion Solutions delivers electric propulsion and power management performance, with innovative products and solutions that advance vehicle mobility, efficiency and capability in the transit, military, marine and rail markets.

Our strategy in action
Continue to grow our electronic systems business

Increasing production of electronic warfare systems

In September, we delivered the 250th electronic warfare suite for the F-35 Lightning II combat aircraft programme, the world's largest defence programme. The advanced technology helps pilots to identify, monitor, analyse and respond to potential threats.

Driven by growth in our electronic warfare programmes, the business is making an investment of more than $100m (£81m) in our 'Ramp 2 Rate' initiative to improve our efficiency and capacity in defence electronics production over the next decade. This investment includes the construction of an Electronic Warfare Integrated Manufacturing Centre, modernised with advanced manufacturing capabilities in robotics and automation.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.
3. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

Operational and strategic highlights

- Delivered the 250th electronic warfare suite for the F-35 Lightning II combat aircraft programme
- Initiated our 'Ramp 2 Rate' capital investment strategy to support growth in defence electronics production
- Awarded a $146m (£118m) engineering and manufacturing development contract for the US Air Force's Eagle Passive Active Warning Survivability System
- Signed a three-year Indefinite Delivery, Indefinite Quantity contract for Advanced Precision Kill Weapon System (APKWS™) Full-Rate Production Lots 5 to 7, worth up to $600m (£486m)
- Awarded a $249m (£201m) contract modification on the Common Missile Warning System programme
- Awarded a contract on the US Army's Family of Weapon Sights – Crew Served programme worth up to $384m (£311m)
- Integration of the GEOINT-ISR business transferred from Cyber & Intelligence completed

Financial performance

Financial performance measures as defined by the Group

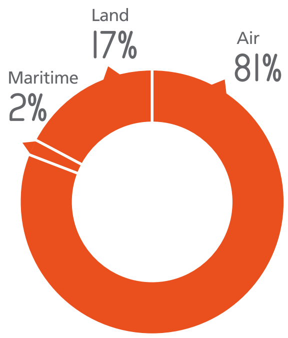
		2016	2015[3]
Sales	KPI	**£3,282m**	£2,922m
Underlying EBITA	KPI	**£494m**	£437m
Return on sales		**15.1%**	15.0%
Operating business cash flow	KPI	**£469m**	£370m
Order intake[1]	KPI	**£3,322m**	£2,799m
Order backlog[1]		**£5.2bn**	£4.4bn

Financial performance measures defined in IFRS[2]

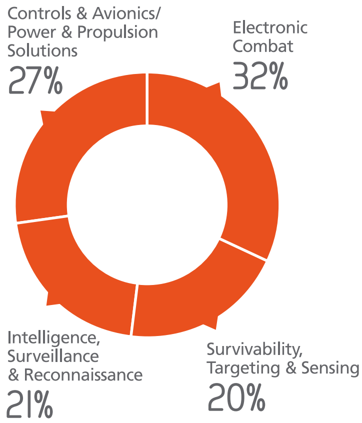
	2016	2015[3]
Revenue	**£3,282m**	£2,922m
Operating profit	**£474m**	£419m
Return on revenue	**14.4%**	14.3%
Cash flow from operating activities	**£568m**	£445m

- Sales compared with 2015 were almost unchanged at $4.4bn (£3.3bn). The commercial areas of the business now amount to 24%, having seen sales growth in the year of 11% primarily in HybriDrive® systems. On the defence side, sales were slightly down on timing of production deliveries on the Digital Electronic Warfare System and other electronic warfare programmes.
- The return on sales achieved of 15.1% (2015 15.0%) was largely from continued strong programme execution and risk retirement.
- Cash conversion of underlying EBITA for the year was at 97%, excluding pension deficit funding.
- Order backlog[1] was sustained at $6.5bn (£5.2bn) benefiting from awards for F-35 Lightning II electronic warfare systems, the F-15 Eagle Passive Active Warning Survivability System programme and APKWS™.

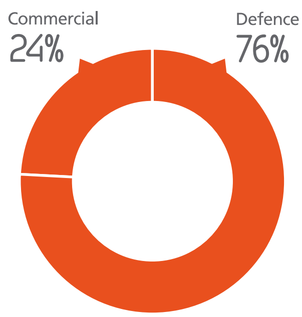
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Defence and commercial (%)



P06–07
Alternative performance measure definitions

Segmental performance
Electronic Systems

Operational performance

Electronic Combat

BAE Systems has sustained its leadership position in the US electronic warfare and communications and navigation markets. Production is ramping up across a number of programmes. Low-Rate Initial Production hardware deliveries on the F-35 Lightning II programme continue with Lot 9 and 10 deliveries. We have received initial funding for Lot 11 with deliveries expected to commence in 2018.

The business is under contracts, from Boeing and Warner Robins Air Logistics Complex, totalling more than $1.0bn (£0.8bn) to install the Digital Electronic Warfare System on 84 new F-15 aircraft, upgrade 70 existing F-15 aircraft, and provide spare units and modules for an international customer. The programme remains on schedule.

In 2015, we were selected by Boeing to develop and manufacture the next-generation digital electronic warfare system for the US Air Force's Eagle Passive Active Warning Survivability System programme to upgrade up to 400 F-15 aircraft. In 2016, we received the engineering and manufacturing development contract, worth $146m (£118m), as a follow-on to the technology maturation and risk reduction phase. The programme could be worth more than $1.0bn (£0.8bn) over its life.

In January 2017, BAE Systems was awarded a $67m (£54m) modification to exercise the option on a previously awarded contract for an electronic warfare system for the US Air Force Special Operations Command's fleet of C-130J aircraft. The award is currently under protest with the Government Accountability Office.

Due to the sensitive nature of electronic combat systems and technology, many of our programmes are classified. As a world leader in electronic warfare, communications and navigation solutions, the business continues to experience growth in these increasingly important areas.

Survivability, Targeting & Sensing

Our Advanced Precision Kill Weapon System (APKWS™) laser-guided rocket is experiencing growing demand, with deliveries exceeding 8,000 units through 2016. In addition to expanding its use in the US military, the system is generating strong international attention, with 16 nations expressing interest. In October, the US Navy awarded us a three-year Indefinite Delivery, Indefinite Quantity contract for Full-Rate Production Lots 5 to 7 worth up to $600m (£486m) that could increase production to 10,000 units per year.

We continue to perform well on the Terminal High-Altitude Area Defence programme, delivering over 90 seekers in 2016 following the $80m (£65m) contract received for Lots 7 and 8 during the year.

On the Common Missile Warning System programme, the business was awarded a $249m (£201m) Indefinite Delivery, Indefinite Quantity contract modification to fulfil increased demand from our customers, the US Army and allied nations, extending the current five-year contract by two years.

On the Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual programme, we completed the first round of qualification and reliability testing in September under a five-year, $434m (£351m) Indefinite Delivery, Indefinite Quantity contract.

On the US Army's Family of Weapon Sights – Crew Served programme, we were awarded a seven-year contract with a potential value of up to $384m (£311m) in September. The sight is designed to allow soldiers to acquire and engage targets at extended range.

We continue to leverage our technology and engineering capabilities, and the LiteHUD® head-up display has been selected by critical launch customers for integration on multiple platforms.

The next-generation Striker® II helmet-mounted display has completed the second phase of flight trials to integrate the system's technology with the Typhoon combat aircraft.

Our strategy in action
Continue to grow our electronic systems business

Growing demand for APKWS™ laser-guided rockets

Electronic Systems' Advanced Precision Kill Weapon System (APKWS™) supports fixed and rotary-wing platforms, and is the only US government programme of record for 2.75-inch guided rockets. Offering a low-cost surgical strike capability, the system was successfully used in theatre on the US Air Force F-16 and A-10 aircraft, as well as the US Marine Corps AV-8B Harrier in 2016. We were awarded a contract worth up to $600m (£486m) to meet the needs of the US Navy, Marine Corps, Army and Air Force, and a growing number of allied nations.

More online
baesystems.com

Intelligence, Surveillance & Reconnaissance
In 2016, Cyber & Intelligence's Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance (GEOINT-ISR) business transferred to Electronic Systems and was merged with the sector's existing Intelligence, Surveillance & Reconnaissance business.

Since winning the Geospatial Data Services Foundational GEOINT Content Management programme in 2014, we have been awarded orders valued at $170m (£138m) and the business is meeting all delivery orders to date. The programme assists US intelligence community customers with the development of advanced geospatial intelligence data collection and processing solutions.

We provide signals intelligence capability for the US Army and other US Department of Defense customers and have received incremental funding for additional production and a technical refresh of Tactical Signals Intelligence Payloads for the US Army's Gray Eagle unmanned aircraft, bringing the total contract value to approximately $116m (£94m).

The business is in Full-Rate Production on the US Navy's P-8A Poseidon maritime surveillance aircraft programme, providing state-of-the-art processing capabilities. We delivered 18 mission computer and display systems in 2016, and received a $60m (£49m) contract for Full-Rate Production Lot 4 in December.

Controls & Avionics
BAE Systems is a major supplier to Boeing for flight controls, and cabin and flight deck systems. Development of the integrated flight control electronics and remote electronic units for Boeing's next-generation 777X aircraft is on schedule, with the Critical Design Reviews for all system components complete and systems integration testing in progress. On the Boeing 737 MAX aircraft, flight testing of our spoiler controls, flight deck systems and utilities is progressing well, with the first production hardware delivered in November. The Bombardier C Series aircraft entered service equipped with BAE Systems' flight control electronics.

FADEC Alliance, a joint venture between FADEC International (the Group's joint venture with Safran Electronics & Defense) and GE Aviation, is now on contract to provide the full authority digital engine controls (FADEC) for: the Leap engine on the Airbus A320neo, Boeing 737 MAX and Comac C919; the Passport 20 engine on the Bombardier Global 7000/8000; the GE9x engine on the Boeing 777X; and a new generation of advanced turboprop engines.

We completed qualification of an active control side-stick for the Gulfstream G500/G600 aircraft, with testing nearing completion for the Embraer KC-390. The product will be the first civil-certified active control side-stick with application across both commercial and military markets.

On the F-35 Lightning II programme, the business completed Low-Rate Initial Production Lot 9 deliveries of 57 production shipsets, plus spares, of the vehicle management computer and active inceptor system equipment. Both systems are now in production for Lot 10 and we expect to be under contract for Lot 11 in 2017.

Power & Propulsion Solutions
In 2016, the business delivered more than 1,000 hybrid-electric propulsion systems to transit agencies around the world and, in November, achieved the milestone of having 7,000 hybrid-electric propulsion systems in service.

Cities including London, Paris, Seattle and Boston are using our hybrid and electric drive systems to save fuel and prevent CO_2 emissions.

We continued to increase our global presence with Solaris Bus & Coach in Poland offering our hybrid-electric system on its buses from September.

Looking forward

In the US, following the two-year Bipartisan Budget Act signed in 2015, there are signs of a return to growth in defence budgets, with the new administration expected to further increase defence and security spending.

Electronic Systems is well positioned to address current and evolving priority programmes from its strong franchise positions in electronic warfare, electro-optics and Intelligence, Surveillance and Reconnaissance. Electronic Systems has a long-standing programme of research and development, and its focus remains on maintaining a diverse portfolio of defence and commercial products and capabilities for US and international customers.

The business expects to benefit from its franchise positions, particularly on the F-35 Lightning II and F-15 upgrade programmes, and its ability to apply innovative technology solutions that meet defence customers' changing requirements. In the commercial aviation market, Electronic Systems' technology innovations are enabling the business to renew long-standing customer positions and to compete for and win new business.

Segmental performance

Cyber & Intelligence

Cyber & Intelligence, with 11,800 employees[1], comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence business, and covers the Group's cyber security, secure government, and commercial and financial security activities.

Intelligence & Security delivers a broad range of services to the US military and government.

Global Analysis & Operations provides innovative, mission-enabling analytic solutions and support to the US government.

Integrated Electronics & Warfare Systems provides systems engineering, integration and through-life support services for US defence and coalition partner customers.

IT Solutions delivers operational secure solutions that enable US national security customers to perform operations and protect their data and networks.

Applied Intelligence provides data intelligence solutions which enable governments and commercial organisations to defend against national-scale threats, protect their networks and data against sophisticated attacks and operate successfully in cyberspace. Its solutions are delivered as licensed technologies, software-as-a-service subscriptions, through outsourced managed services, and via consulting and systems integration projects.

Commercial Solutions provides cyber defence, counter-fraud and financial compliance products to commercial organisations globally.

UK Services delivers cyber security, data analytics, and digital transformation consulting and systems integration services to national security, government and large enterprises in the UK.

International Services & Solutions provides cyber intelligence and defence solutions to international government agencies and communications service providers.

Our strategy in action
Accelerate the growth of our cyber, intelligence and security business

Strategic alliances to drive cyber growth

We are accelerating the growth of our cyber security business through the creation of strategic alliances with organisations in adjacent markets. Our alliance partners include telecommunications providers Vodafone and Telefonica, and CSC in the IT services industry.

We offer our technology, consultancy and managed security services to our partners and their customers. This enables us to monitor their networks for attempted data breaches and malware to identify and respond to suspicious activity, keeping their networks safe.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.
3. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

Operational and strategic highlights

Intelligence & Security

- Established prime positions under a five-year imagery analysis, training and support contract worth an estimated $350m (£283m)
- Awarded a five-year contract valued at up to $368m (£298m) to integrate weapon systems aboard US and UK submarines
- Awarded task orders totalling more than $240m (£194m) to provide information technology services to the US government

Applied Intelligence

- Second year of expanded investment in product development, and sales and marketing driving continued growth in commercial cyber security and counter-fraud
- 'Business Defence' marketing campaign is generating new leads in the commercial business
- Continued shift towards multi-year managed services and subscription-based, cloud-delivered products in the commercial sector
- Good execution of cyber defence and intelligence programmes for UK and international government customers

Financial performance

Financial performance measures as defined by the Group

		2016	2015[3]
Sales	KPI	£1,778m	£1,564m
Underlying EBITA	KPI	£90m	£104m
Return on sales		5.1%	6.6%
Operating business cash flow	KPI	£83m	£46m
Order intake[1]	KPI	£1,885m	£1,753m
Order backlog[1]		£2.4bn	£2.2bn

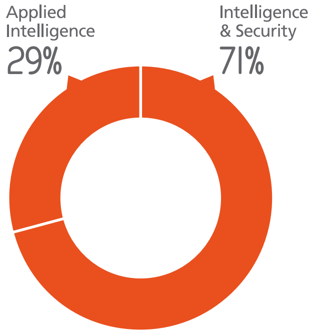
Financial performance measures defined in IFRS[2]

	2016	2015[3]
Revenue	£1,778m	£1,564m
Operating profit/ (loss)	£59m	£(31)m
Return on revenue	3.3%	(2.0)%
Cash flow from operating activities	£106m	£70m

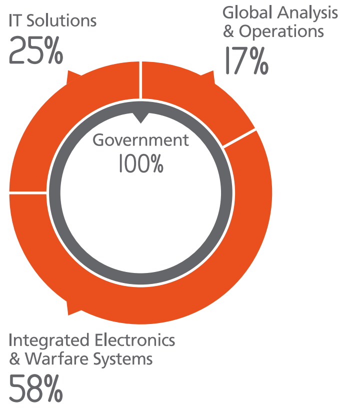
- In aggregate, sales were marginally higher at $2.4bn (£1.8bn). The Intelligence & Security business saw a 2% increase largely in the area of provision of managed services to the intelligence community. Growth in the Applied Intelligence business was at 11%, benefiting from increases in the Commercial Solutions and UK Services divisions.
- The return on sales achieved was 5.1% (2015 6.6%). Higher levels of costs expensed in the Applied Intelligence business, together with delays in securing software licence sales, meant that there was a loss recorded in the business of £19m. In the year, the total cost base of the business (labour and overheads) amounted to more than £480m, all of which was expensed through the income statement.
- There was an operating loss in the prior year due to the impairment of goodwill in the Intelligence & Security business reflecting lower business growth assumptions.
- Cash conversion of underlying EBITA for the year was in excess of 100%, excluding pension deficit funding.
- In aggregate, order backlog[1] reduced to $3.0bn (£2.4bn). Order backlog in the Intelligence & Security business was 5% lower on trading out of certain longer-term contracts. In the Applied Intelligence business, order backlog increased by 9% over the year driven mainly by UK government services and commercial awards.

P06–07
Alternative performance measure definitions

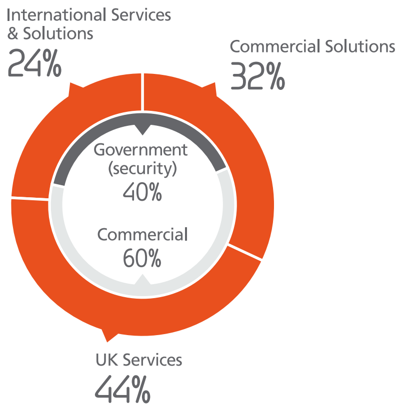
Sales by business (%)



Sales analysis: Intelligence & Security (%)



Sales analysis: Applied Intelligence (%)



Segmental performance
Cyber & Intelligence

Operational performance

Intelligence & Security

Global Analysis & Operations
In Full-Motion Video and Intelligence, Surveillance and Reconnaissance analysis, we have more than 500 analysts sustaining mission-critical activities globally. These security-cleared analysts are currently executing on programmes with a combined value of more than $400m (£324m). Re-compete awards for many of these programmes are being awarded under a new Indefinite Delivery, Indefinite Quantity contract. We have established a prime position on two of the three functional areas under this contract, worth an estimated $350m (£283m) over five years, which could enable us to expand our work in motion-imagery analysis, analytic training, multi-media support and research. Award of a third functional area under this contract is expected in 2017.

We are currently performing under the first year of a five-year contract with an estimated ceiling value of $75m (£61m) to provide the US Army with geospatial intelligence data analysis support services and the business is fulfilling the third year of a five-year contract worth up to $143m (£116m) to provide counter-terrorism analysis services to the US government.

Integrated Electronics & Warfare Systems
We have been awarded a five-year, sole-source contract worth up to $368m (£298m) by the US Navy to assist with system integration and provide test engineering services and special test equipment for weapons systems on board US Ohio and UK Vanguard Class submarines.

Other US Navy awards in the year include: a five-year contract worth up to $86m (£70m) to provide management, engineering, maintenance and IT support services for critical mission equipment and combat services used by Naval Sea Systems Command; a two-year, $73m (£59m) contract from the Naval Air Warfare Center Aircraft Division to provide lifecycle support services for communications and electronics equipment and subsystems; and a five-year, $52m (£42m) contract to provide essential maintenance and testing support for various air traffic control and landing systems.

Our strategy in action
Accelerate the growth of our cyber, intelligence and security business

International cyber defence partnering

Under a partnership with Fujitsu of Japan, our cyber security engineers developed a new set of tools to enable and improve Cyber Threat Intelligence (CTI) sharing across national and organisational boundaries. This is one of the first times actual fused intelligence has been shared between international companies. Our unique approach supports the introduction of machine learning techniques enabling the automation of policy enforcement to ensure CTI sharing complies with requirements related to sensitive information. This innovative project has resulted in a key cyber defence discriminator that we can leverage in pursuit of future cyber defence opportunities with the US Army and Air Force.

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We continued to support the US Navy's Space and Naval Warfare Systems Center Atlantic, to integrate new C4I (Command, Control, Communications, Computers and Intelligence) equipment on approximately 6,000 Mine Resistant Ambush Protected vehicles over a five-year period, with more than 2,000 vehicles serviced in 2016.

We were awarded a two-year, $16m (£13m) task order by the US Army's Space and Missile Defense Command/Army Strategic Command to continue the development of specialised cyber vulnerability assessment tools to harden and protect space assets. We also secured a two-year, $13m (£11m) task order to build a Cyber Warrior Training Capability in support of the Missile Defense Agency.

Under the US Air Force's Intercontinental Ballistic Missile Integration Support Contractor programme, we were awarded more than $190m (£154m) in additional engineering scope change proposals in 2016, which has resulted in the total contract lifecycle value reaching nearly $900m (£728m) since we began managing the programme in 2013.

IT Solutions
We are executing the first of several task orders to provide IT services to high-priority US government agencies under a ten-year, single-award Indefinite Delivery, Indefinite Quantity contract awarded in 2015 with a potential value of more than $1.0bn (£0.8bn), under which task orders totalling approximately $240m (£194m) have been awarded to date.

Under the Enhanced Solutions for the Information Technology Enterprise (e-SITE) Indefinite Delivery, Indefinite Quantity contract for the Defense Intelligence Agency, we were awarded a five-year, $58m (£47m) re-compete task order to continue designing, developing, engineering, installing and sustaining information technology resources.

The US Air Force Research Laboratory awarded the business a five-year contract worth up to $49m (£40m) to develop, deploy and maintain cross-domain solutions for safeguarding the sharing of sensitive information between government networks.

Applied Intelligence

The business has continued to invest in commercial cyber security and counter-fraud product development, and sales and marketing to drive revenue growth. A 'Business Defence' marketing campaign, launched initially in the US, is generating new leads in the commercial business. We have continued to build our cyber skills and engineering capabilities internationally. During the year, we opened a 'Nerve Centre' in Malaysia, a state-of-the-art facility that supports our global cyber security, anti-financial crime and threat intelligence capabilities.

Commercial Solutions

The business continues to shift towards more multi-year managed services and subscription-based, cloud-delivered products. During the year, an enhanced Managed Security Services offering to enterprise-class customers was launched in the US, building on the success of our existing mid-market offering. We have seen growth in managed security services through partnerships with regional communications service providers in the UK and North America.

The business continues to sell licensed 'on premise' software products, with awards in the year including a pilot with a major UK financial institution for the CyberReveal™ threat analytics solution, which defends large enterprises against sophisticated cyber-attacks.

We have continued to extend our position in counter-fraud and financial compliance with further sales of multi-year service offerings, including a five-year contract to provide a customised NetReveal™ counter-fraud analytics solution for HM Revenue & Customs in the UK and the extension of the managed fraud detection service for the Insurance Fraud Bureau in the UK to 2020. The business was appointed by SWIFT, the world's leading provider of secure financial messaging services, to join its new Customer Security Intelligence team and has announced an Incident Response partnership with Allianz Global Corporate & Specialty.

UK Services

The business has maintained its position as a key supplier to national security agencies in the UK, with a number of new framework agreements and contract wins, including follow-on work for existing customer programmes.

Demand for cyber security services from large enterprises has continued, with a two-year cyber security support contract in the transport sector and the extension of a team delivering cyber security advisory services for a UK telecommunications operator.

The data and digital transformation business continues to grow, with new contracts covering a team delivering aspects of IT transformational change in HM Revenue & Customs to the final quarter of 2017 and collaboration in the Digital Railway programme helping to develop an industry architecture and capability development framework for the UK rail industry. We have won a number of service integration and management advisory contracts in central government departments.

International Services & Solutions

We have seen continued demand in Asia-Pacific, Europe and the Middle East for protection against national threats. A pilot advanced cyber threat analytics and investigation solution on a national telecommunications network in Asia was successfully implemented during the year and there has been growth in business with top-tier telecommunications providers in Australia.

The latest release of the IntelligenceReveal™ all-source analysis solution, which enables customers to view a single, unified intelligence picture, has supported the implementation of a large programme for a strategic law enforcement customer. We have also won a contract to build a technology demonstrator in the UK that allows users to move information between security domains without compromising confidentiality, integrity or availability.

Looking forward

Intelligence & Security

Following a period of market contraction in the US government services sector, the Group believes the outlook is now stable with market conditions remaining highly competitive.

The Intelligence & Security business has continued to reduce costs to address government budget pressures, whilst pursuing growth opportunities, particularly in critical, mission-focused areas.

Applied Intelligence

Investment continues in product development, sales and marketing, and building cyber and engineering capabilities in the UK and international markets.

The business continues to migrate towards a multi-year managed service and subscription-based model, providing enhanced predictability of revenues, and growing further the order backlog and pipeline of opportunities from commercial and government customers in North America, Europe, Asia-Pacific and the Middle East.

Segmental performance
Platforms & Services (US)

Platforms & Services (US), with 11,300 employees[1], has operations in the US, UK and Sweden. It produces combat vehicles, weapons and munitions, and delivers services and sustainment activities, including ship repair and the management of government-owned munitions facilities.

US Combat Vehicles focuses on a portfolio of tracked combat vehicles, amphibious vehicles, accessories, protection systems and tactical support services for the US military and international customers.

Weapon Systems and Munition Operations focuses on naval weapons, artillery, advanced weapons, precision munitions, high explosives and propellants for US, UK and international customers.

Services include complex munition site management for the US Army's Holston and Radford facilities.

US Ship Repair and Modernisation is a major provider of non-nuclear ship repair, modernisation, overhaul and conversions to the US Navy, government and commercial maritime customers. It has six operational sites in the US on the Atlantic, Gulf of Mexico and Pacific coasts, as well as in Hawaii.

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

FNSS, the Turkish land systems business in which BAE Systems holds a 49% interest, produces and upgrades tracked and wheeled military vehicles for domestic and international customers.

Our strategy in action
Continue to win new international orders

Expanding our international footprint

In 2016, Platforms & Services (US) increased its international profile in the land domain, with awards for M113 vehicle upgrade kits and upgraded M109A5+ self-propelled howitzers to Brazil; Assault Amphibious Vehicles to Japan; BvS10 vehicles to Austria; refurbished CV90 vehicles for Sweden; and M777 lightweight howitzers to India in January 2017.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

Operational and strategic highlights

- Roll-out of the first prototype Armored Multi-Purpose Vehicle for the US Army and delivery of the first prototype Amphibious Combat Vehicles for the US Marine Corps
- 34 vehicle sets delivered to the US Army under the M109A7 Paladin self-propelled howitzer programme
- Commenced production of 30 Assault Amphibious Vehicles for Japan under a $160m (£129m) contract
- £183m contract received in July for the gun system on the UK Type 26 frigate
- Secured a $542m (£439m) contract to provide 145 M777 lightweight howitzers to India in January 2017
- Received a $182m (£147m) contract to refurbish and upgrade 262 CV90 Infantry Fighting Vehicles for Sweden
- FNSS awarded a contract to supply 260 Anti-Tank Vehicles to the Turkish Land Forces worth more than €278m (£237m)
- The arrival of a new dry dock at the San Diego shipyard to expand capabilities for servicing US Navy ships

Financial performance

Financial performance measures as defined by the Group

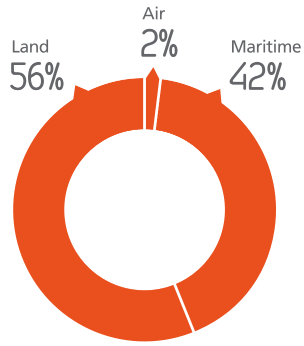
		2016	2015
Sales	KPI	£2,874m	£2,779m
Underlying EBITA	KPI	£211m	£177m
Return on sales		7.3%	6.4%
Operating business cash flow	KPI	£58m	£100m
Order intake[1]	KPI	£3,308m	£2,737m
Order backlog[1]		£4.6bn	£3.9bn

Financial performance measures defined in IFRS[2]

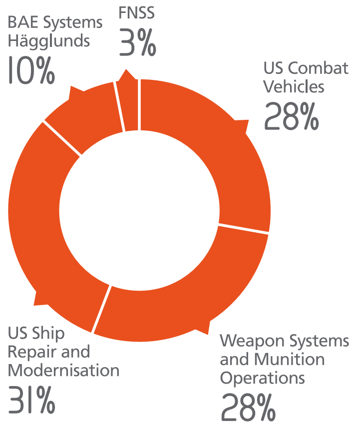
	2016	2015
Revenue	£2,783m	£2,678m
Operating profit	£182m	£142m
Return on revenue	6.5%	5.3%
Cash flow from operating activities	£129m	£144m

- Sales in the year declined by 8% to $3.9bn (£2.9bn). The sales reduction in the naval ship repair business was less than expected, with stronger volumes through our Norfolk yard.
- The business has delivered an improved return on sales of 7.3% (2015 6.4%). Whilst further charges had to be taken in the year on the commercial shipbuilding programmes, these were partly offset by provision releases, primarily on the Radford munitions contract. The net impact of these charges and releases was 1.3 percentage points on return on sales.
- Cash conversion of underlying EBITA was impacted by the use of provisions on the commercial shipbuilding programmes and of customer advances on the CV90 Norway contract, along with the investment, now completed, on the new floating dry dock facilities in San Diego.
- Order backlog[1] was almost unchanged at $5.7bn (£4.6bn). The trading out of the five-year Multi-Ship, Multi-Option contracts in the ship repair business and on the CV90 Norway programme were largely offset by multiple domestic and international land vehicle awards along with the gun contract for the UK's Type 26 frigate. The Indian M777 lightweight howitzer award for $542m (£439m) was not contracted until January 2017.

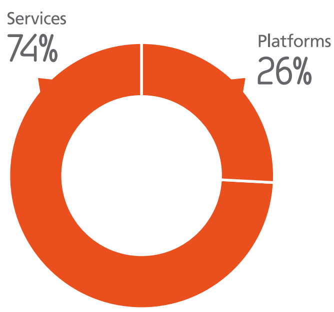
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



P06–07
Alternative performance measure definitions

Segmental performance
Platforms & Services (US)

Operational performance

US Combat Vehicles

The business continues to hold a number of key franchise programmes, including the long-standing Bradley Infantry Fighting Vehicle, the M109 family of vehicles, the M88 Heavy Recovery Vehicle, the Assault Amphibious Vehicle and the more recent Armored Multi-Purpose Vehicle, with future prospects including the Amphibious Combat Vehicle 1.1 programme.

We have rolled out the first of 29 vehicles under the engineering and manufacturing development phase of the US Army's Armored Multi-Purpose Vehicle programme. The potential contract value for the initial phase of the programme is $1.2bn (£1.0bn), including options for 289 vehicles in Low-Rate Initial Production. Anticipated Full-Rate Production is expected to approach 3,000 vehicles.

We continue to execute on the $670m (£542m) Low-Rate Initial Production phase of the M109A7 Paladin self-propelled howitzer programme to deliver 66 vehicle sets and an additional howitzer. At 31 December, 34 vehicle sets, together with the additional howitzer, had been delivered. The US Army's total acquisition objective through all programme phases is for 581 vehicle sets.

The business is executing a $286m (£231m) Engineering Change Proposal to address the space, weight, power and cooling limitations of the Bradley family of vehicles as well as preparing the vehicle for communication network upgrades. In 2017, the customer's production decision is expected regarding the upgrade of approximately 500 vehicles over a three-year period from 2019.

In April, we received a contract valued at $110m (£89m) from the US Army to convert 36 M88A1 recovery vehicles to the M88A2 Heavy Equipment Recovery Combat Utility Lift Evacuation Systems (HERCULES) configuration. Deliveries are scheduled to begin in November 2017.

Along with industry partner Iveco Defence, BAE Systems has begun deliveries of the first of 16 Amphibious Combat Vehicle 1.1 prototypes under a $104m (£84m) contract for the engineering and manufacturing development phase of the programme. Testing by the US Marine Corps will start in the first half of 2017 and final down-selection to a single manufacturer is expected in 2018.

Leveraging our expertise in amphibious capabilities, we were awarded contracts totalling $160m (£129m) for the production of 30 new Assault Amphibious Vehicles (AAV) and the upgrade of two AAV for the Japanese Ministry of Defence.

Our strategy in action
Leverage our technology and engineering capabilities

Next-generation Bradley focuses on the future

In October, BAE Systems unveiled its Next-Generation Bradley Infantry Fighting Vehicle demonstrator. Internally funded, the Bradley demonstrator leverages current and new technologies to significantly improve mobility, force protection and lethality.

The vehicle was engineered to adapt solutions from other BAE Systems platforms to support commonality across the US Army's fleet of combat vehicles. It features an upgraded chassis to increase the protection of troops, and more space to accommodate larger soldiers and electrical power for future technology insertion to help to ensure that the US Army can successfully execute its missions in the coming decades.

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In April, we received a contract valued at $50m (£40m) to deliver 236 M113 upgrade kits and technical support for the Brazilian Army, with contract deliveries scheduled to complete in 2018. In September, the Brazilian government awarded the business a $54m (£44m) contract to provide 32 upgraded M109A5+ self-propelled howitzers.

Weapon Systems and Munition Operations

BAE Systems remains a leading provider of gun systems and precision strike capabilities, and continues work with the US Navy on the development of the Hyper Velocity Projectile and the Electromagnetic Railgun.

In April, we received multiple awards from the US Navy, including a $38m (£31m) contract modification to provide additional missile canisters for the Mk 41 Vertical Launching System and a $72m (£58m) contract to produce and deliver propulsor systems for Block IV Virginia Class submarines.

In August, the US Navy exercised a $50m (£40m) contract option to upgrade four additional Mk 45 gun systems, bringing the total value of the contract to $130m (£105m) for ten systems.

In July, we received a £183m contract from the UK Ministry of Defence to provide the gun system known as the Maritime Indirect Fire System for the Royal Navy's Type 26 frigate.

Deliveries to the Swedish government of the 24 Archer artillery systems were completed in December. In September, the Swedish government announced its intent to purchase the additional 24 Archer systems originally contracted for Norway.

In February 2017, we completed the acquisition of IAP Research, an engineering company focused on the development and production of electromagnetic launchers, power electronics and advanced materials.

In the complex infrastructure operations business, we manage the US Army's Radford and Holston munitions facilities. In the year, we were awarded $85m (£69m) in contract modifications at Holston for waste water management, followed by a $146m (£118m) contract in October to construct a nitric acid recovery facility to increase capacity for producing insensitive munitions. In September, we received a $69m (£56m) contract for continued production of MK 90 propellant grain.

In November, the US and Indian governments signed a Letter of Agreement for the Foreign Military Sale of 145 M777 lightweight howitzers and, in January 2017, we received the $542m (£439m) contract from the US government to supply these howitzers to the Indian Army. We have selected Mahindra & Mahindra as our supplier to establish an assembly, integration and test facility in India in support of the Indian Prime Minister's 'Make in India' initiative.

US Ship Repair and Modernisation

We are a leading provider of ship repair and modernisation services. In 2016, we secured firm orders across our US shipyards totalling approximately $1.1bn (£0.9bn) and the business remains well positioned to compete for future contracts in the maritime domain.

We continue to adjust our workforce and facilities to meet the evolving demand for US Navy ship repair. To support the US Navy's re-balance to the Asia-Pacific region, a new dry dock arrived in our San Diego shipyard in December and became operational in February 2017. The USS New Orleans, an amphibious dock landing ship, will be the first vessel to be serviced in the dry dock under a $37m (£30m) contract received in November.

In commercial shipbuilding, we continued to experience challenges in the year, taking a $73m (£54m) charge against ongoing contracts. Workforce adjustments continue as these contracts near completion. Six ships have now been accepted by customers, with the remaining two ships expected to complete in 2017.

In January 2017, we completed the sale of our BAE Systems San Francisco Ship Repair business enabling us to focus on our larger, retained shipyards providing strong capabilities and support to our key maritime customers, including the US Navy.

BAE Systems Hägglunds

Series production continues on the $865m (£700m) contract awarded in 2012 for the supply of CV90 Infantry Fighting Vehicles to Norway.

In addition to production of CV90 vehicles, we have been awarded contracts for refurbishment and upgrade. In March, we were awarded a contract valued at $182m (£147m) to refurbish 262 CV90 vehicles for the Swedish Army and, in September and October, two contracts from the Danish government for sustainment and upgrade of its CV90 fleet. In December, the Swedish government awarded us a $68m (£55m) contract for the integration of Mjölner mortar systems on 40 CV90s, and we received a contract from the Dutch government for testing and verification of Active Protection Systems on CV90s.

In June, we were awarded a contract to produce 32 BvS10 military vehicles for Austria, the fifth nation to acquire the all-terrain vehicle.

FNSS

FNSS, our land systems joint venture based in Turkey, has continued to perform under its $524m (£424m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army.

Production remains on schedule under a contract to upgrade M113 tracked armoured personnel carriers for the Royal Saudi Land Forces and, in 2016, the business received a contract to integrate mortar systems.

In support of a customer contract awarded in 2015 to supply the PARS Wheeled Armoured Vehicle, work has begun to deliver 8x8 and 6x6 vehicles in a number of configurations.

In June, FNSS was awarded a contract worth more than €278m (£237m) to supply 260 Anti-Tank Vehicles to the Turkish Land Forces. The scope of the project includes both tracked and wheeled vehicles equipped with anti-tank guided missile system turrets.

In December, FNSS signed an €84m (£72m) contract with ASELSAN, a Turkish defence electronics company, for amphibious tracked armoured vehicles for the Turkish Land Forces.

Looking forward

In the US, following the two-year Bipartisan Budget Act signed in 2015, there are signs of a return to growth in defence budgets, with the new administration expected to further increase defence and security spending.

The business is underpinned by strong positions on key franchise programmes. In the land domain, this includes the US Army's Armored Multi-Purpose Vehicle, Bradley and Paladin programmes and the CV90 and BvS10 export programmes from our BAE Systems Hägglunds business.

FNSS has grown its order book with both domestic and international orders secured during 2016.

These long-term contracts, our strong franchise in tracked vehicles and opportunities in international markets, position the land business for a return to growth in the medium term.

In the maritime domain, the Group has a strong position on naval gun programmes and US Navy ship repair. Additional dry dock ship repair capacity has been established in San Diego to support the US Navy's re-balance to the Asia-Pacific region.

The business continues to pursue a range of domestic and international opportunities in combat and amphibious vehicles, weapons systems and maritime support services.

Segmental performance

Platforms & Services (UK)

Platforms & Services (UK), with 30,100 employees[1], comprises the Group's UK-based air, maritime, land and shared services activities.

Military Air & Information includes programmes for the production of Typhoon combat and Hawk trainer aircraft, F-35 Lightning II manufacture and support, support and upgrades for Typhoon, Tornado and Hawk aircraft, and development of next-generation Unmanned Air Systems and defence information systems.

Maritime programmes include the construction of two Queen Elizabeth Class aircraft carriers, five River Class Offshore Patrol Vessels and seven Astute Class submarines for the Royal Navy, the design and production of the Dreadnought Class submarine and Type 26 frigate, and in-service support, including the five-year contract secured in 2014 for the delivery of services at HM Naval Base, Portsmouth.

Land (UK) provides combat vehicle upgrades and support to the British Army and international customers, and designs, develops and manufactures a comprehensive range of munitions products servicing its main customer, the UK Ministry of Defence, as well as international customers. The business also develops and manufactures cased-telescoped weapons through its CTA International joint venture.

Our strategy in action
Continuously improve efficiency and competitiveness

UK Typhoon support contract

In July, we announced an innovative ten-year partnership arrangement, expected to be worth at least £2.1bn, to support the Royal Air Force's fleet of Typhoon combat aircraft. Working closely with the Royal Air Force, we aim to substantially reduce current support and maintenance cost. Under the terms of the arrangement, there is potential for a proportion of these savings to be reinvested to develop new capabilities for the aircraft.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

Operational and strategic highlights

- £1.0bn of orders for our workshare on 28 Typhoon aircraft for Kuwait
- Partnership arrangement for support to the UK Typhoon fleet expected to be worth at least £2.1bn over a ten-year period
- F-35 Lightning II orders worth £637m, including Lot 10 production and construction of engineering and training facilities in the UK, and the UK selected as European regional avionics and component repair hub
- £472m extension to the Type 26 frigate demonstration phase contract and UK government commitment to manufacture eight ships
- £287m contract awarded for two additional Offshore Patrol Vessels, including support services for the five-ship programme
- Reactor core successfully loaded on the fourth Astute Class submarine
- £1.3bn of funding received for Dreadnought Class submarine design, initial manufacture, materials and facilities investment
- Down-selected as one of two contenders for the Challenger 2 Life Extension Programme
- £445m order on the Munitions Acquisition Supply Solution partnering agreement for five years of supply

Financial performance

Financial performance measures as defined by the Group

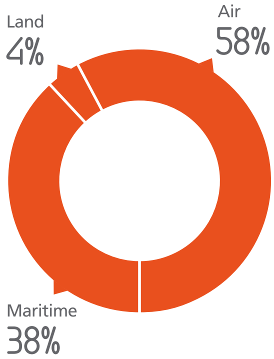
		2016	2015
Sales	KPI	£7,806m	£7,405m
Underlying EBITA	KPI	£810m	£721m
Return on sales		10.4%	9.7%
Operating business cash flow	KPI	£199m	£220m
Order intake[1]	KPI	£8,024m	£4,944m
Order backlog[1]		£17.8bn	£17.8bn

Financial performance measures defined in IFRS[2]

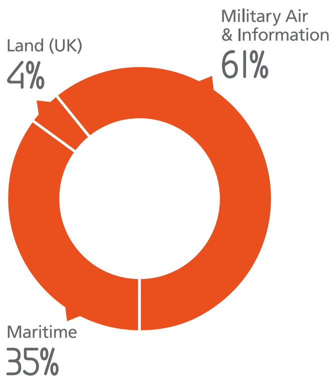
	2016	2015
Revenue	£7,699m	£7,319m
Operating profit	£780m	£756m
Return on revenue	10.1%	10.3%
Cash flow from operating activities	£385m	£289m

- The year's sales of £7.8bn were 5% higher than 2015. The increase came from the expected ramp up on F-35 Lightning II deliveries and Saudi trainer aircraft. Activity and milestone performance on the submarine programmes was ahead of plan. There was also a higher level of intercompany activity under the Saudi support contracts which is eliminated at the Group level.
- The return on sales was 10.4% (2015 9.7%).
- Cash performance was better than expected, with an operating business cash inflow of £199m (2015 £220m). Consumption of customer advances occurred on the Omani, Saudi and European Typhoon contracts, albeit some early receipts on the Omani contract mitigated that to a limited extent.
- Order backlog[1] was stable at £17.8bn (2015 £17.8bn). Sales trading on the Typhoon aircraft and aircraft carrier programmes was replaced by the ten-year UK Typhoon support award and Kuwait Typhoon subcontract.

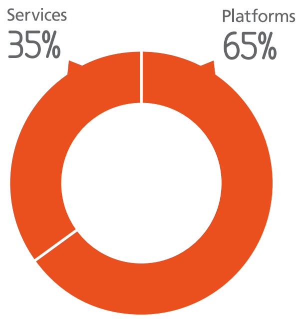
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



P06–07
Alternative performance measure definitions

Segmental performance
Platforms & Services (UK)

Operational performance

Military Air & Information

In the year, 16 Typhoon aircraft were delivered from the UK final assembly facility, of which 11 were delivered to Saudi Arabia. Cumulative aircraft deliveries to the UK, Germany, Italy and Spain total 232 of the contracted 236 Tranche 2 aircraft and 33 of the contracted 88 Tranche 3 aircraft.

The Oman Typhoon and Hawk aircraft programme is on track for commencement of deliveries in 2017.

Orders totalling £1.0bn have been received via Eurofighter from our Italian Eurofighter partner, Leonardo, for BAE Systems' share of work on the 28 Typhoon aircraft for Kuwait covering airframe manufacture, support, capability upgrade and Electronically Scanned (E-Scan) radar integration work.

Typhoon's capabilities continue to be enhanced with the ongoing integration of the Captor E-Scan radar and the Storm Shadow, Meteor and Brimstone 2 missiles as part of European capability delivery programmes. Development towards the Royal Air Force Centurion standard continues, which will enable transition of capability from Tornado to Typhoon.

We have continued to support our UK and European customers' Typhoon and Tornado aircraft and their operational commitments. A ten-year partnership arrangement with the Ministry of Defence to support the UK Typhoon fleet, expected to be worth at least £2.1bn, was signed in July.

On the F-35 Lightning II programme, we completed delivery of 55 aft fuselage assemblies for the Low-Rate Initial Production Lot 9 and 10 contracts. Additional orders were received for Lot 10 during the year, worth £168m, with full contract award expected in 2017 following agreement of the front-end contract between Lockheed Martin and the US government. The proposal for Lot 11 has been submitted to Lockheed Martin in advance of negotiations expected to complete in 2017. A £118m contract to build engineering and training facilities at RAF Marham in Norfolk, UK, has been secured, with work scheduled to be completed in 2018 in readiness for the arrival of the UK's first F-35 Lightning II aircraft. In November, the F-35 Joint Programme Office announced that it had chosen the UK as a major repair hub for the maintenance, repair, overhaul and upgrade of F-35 Lightning II avionics and components, during the period 2021 to 2025 on a global basis and from 2025 onwards for the Europe region.

Support continues to be provided to users of Hawk trainer aircraft around the world. A long-term support contract for the Royal Air Force's UK fleet of Hawk fast jet trainer aircraft was announced in the year and we continue to deliver against all contractual milestones.

In 2016, the Indian Navy and Air Force received three and ten Hawk aircraft, respectively, completing the delivery of all 57 aircraft built under licence by Hindustan Aeronautics Limited (HAL). Negotiations continue with HAL for the supply of 32 aircraft kit sets which will result in aircraft built under licence by HAL for the Indian Air Force and Indian Navy.

In March, we welcomed the announcement by the UK and French governments of a €2bn (£1.7bn) programme to build operationally representative unmanned combat air system demonstrators. This will secure highly-skilled engineering jobs and the first phase is anticipated to commence in 2018.

The UK technology programme for the air sector continues to progress with a successful set of demonstrations in 2016 and further order intake has been received to develop critical systems and capabilities for future unmanned systems and other aircraft.

In Turkey, following a pre-contract study phase between BAE Systems and Turkish Aerospace Industries, we have signed a heads of agreement to collaborate on the first design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force. When on contract, this will have a value in excess of £100m.

Maritime

On the aircraft carrier programme, good progress has been made on commissioning HMS Queen Elizabeth's key systems and the business is working with the Ministry of Defence to prepare the support solution in advance of her expected arrival at HM Naval Base, Portsmouth, in 2017. On HMS Prince of Wales, all of the blocks are now assembled, with large volume installation activities under way. Sea trials on the aircraft carriers are expected to complete in 2017 and 2019, respectively.

In preparation for the manufacturing contract for the Type 26 frigate, a £472m extension to the demonstration phase contract was secured in March, covering detailed design activities and enabling us to subcontract for key equipment with companies throughout the supply chain. The engineering design programme continues to progress to enable commencement of manufacture of the first ship in 2017. The programme currently employs more than 1,000 staff.

Under a heads of terms signed in November, BAE Systems and the Ministry of Defence reached agreement in principle on the award of a contract reflecting the government's intention to build eight Type 26 frigates on the Clyde and a further two River Class Offshore Patrol Vessels. The Offshore Patrol Vessels were contracted in December for £287m, including support services for the five-ship programme.

Our strategy in action
Leverage our technology and engineering capabilities

Developing unmanned boat technology

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In 2016, we successfully demonstrated unmanned boat technology and a bespoke transportable command and control system. A modified Pacific Class 950 Rigid Inflatable Boat took part in the Royal Navy's Unmanned Warrior naval exercise. This system is capable of speeds up to 47 knots and would allow longer duration operations than manned boats. The multi-role vessel could carry out reconnaissance and remote surveillance operations while keeping sailors out of harm's way.

The technology will enable end-to-end command and control of unmanned vehicles and, together with the unmanned boat technology, can track, monitor and intercept threats as they happen. This supports decision-making and helps to keep Royal Navy personnel safe during deployment.

Progress has been maintained on the manufacture of the first three Offshore Patrol Vessels, FORTH, MEDWAY and TRENT. The programme supports shipbuilding skills and provides a bridge for the business between the aircraft carrier programme and manufacture of the Type 26 frigate.

Under the Maritime Support Delivery Framework contract, in place until March 2019, we provide services at HM Naval Base, Portsmouth, and support to half of the Royal Navy's surface fleet. Achievement of target cost remains on track.

BAE Systems manages the support, maintenance and upgrade of the Royal Navy's fleet of Type 45 destroyers.

Progress continues on the £270m Spearfish torpedo upgrade demonstration and manufacture phases, with the demonstration phase currently forecast to complete in 2019.

The first three of seven Astute Class submarines are in operational service with the Royal Navy, with the reactor core load on boat four completed in the second half of the year. Further funding of £228m for the sixth and seventh boats was received in the year. Negotiations for full pricing of the sixth and seventh boats have commenced.

The Ministry of Defence, BAE Systems and Rolls-Royce have signed a heads of terms to set up a Dreadnought Build Alliance documenting the UK government and industry's commitment to the delivery of the Dreadnought Class submarine programme, the replacement for the Royal Navy's Vanguard Class submarine fleet, and setting out an organisational and managerial structure and series of commercial principles necessary to deliver it.

Functional and spatial design continues to advance on the Dreadnought Class submarine. During 2016, £1.3bn of funding was received for continued design, initial manufacture of the first boat, material commitment and facilities investment. Preparations for the manufacture of Dreadnought include a major programme of building works at the Barrow site, with contracts in place totalling more than £300m. The UK government's commitment to the Dreadnought programme was endorsed by Parliament during the year.

Land (UK)

The business provides ongoing support to previously-supplied armoured vehicles and bridging systems, with orders of £56m received in the year. In the UK, the business has been down-selected as one of two contenders to deliver the first stage of the Challenger 2 Life Extension Programme and, in the overseas market, the business secured a multi-year contract for support and maintenance to the Latvian fleet of Combat Vehicle Reconnaissance (Tracked) vehicles purchased from the UK Ministry of Defence.

The first 29 of 515 40mm cased-telescopic cannons were delivered to the Ministry of Defence by CTA International, a 50% joint venture between BAE Systems and Nexter.

The business continues to provide UK and international customers with a full range of light and heavy munitions. We have concluded pricing negotiations on our 15-year Munitions Acquisition Supply Solution partnering agreement with the Ministry of Defence, worth £445m.

Looking forward

Platforms & Services (UK) has an order backlog of long-term committed programmes and an enduring support business. The Strategic Defence and Security Review announced in November 2015 provided clarity, continuity and stability for the UK contracted business and has been consistently implemented through long-term contract awards and commitments.

In Military Air & Information, sales are underpinned by Typhoon and F-35 Lightning II aircraft production and in-service support. There are opportunities to secure further Typhoon export sales building on the purchase of 28 aircraft by Kuwait.

In Maritime, sales are underpinned by the design and subsequent manufacture of the Type 26 frigate and long-term contracts on Queen Elizabeth Class aircraft carriers, River Class Offshore Patrol Vessels, and Astute and Dreadnought Class submarines. The through-life support of existing and new platforms, together with their associated command and combat systems, provides a sustainable business in technical services and mid-life upgrades.

The Land (UK) business is underpinned by the 15-year Munitions Acquisition Supply Solution partnering agreement with the Ministry of Defence secured in 2008 and continues to pursue upgrade programmes with a focus on the Challenger 2 main battle tank.

Segmental performance

Platforms & Services (International)

Platforms & Services (International), with 13,700 employees[1], comprises the Group's businesses in Saudi Arabia, Australia and Oman, together with its 37.5% interest in the pan-European MBDA joint venture.

In Saudi Arabia, the business provides operational capability support to the country's air and naval forces through UK/Saudi government-to-government programmes. The Saudi British Defence Co-operation Programme and Salam Typhoon project provide for multi-year contracts between the governments.

In Australia, the business delivers production, upgrade and support programmes for customers in the defence and commercial sectors across the air, maritime and land domains. Services contracts include the provision of sustainment, training solutions and upgrades.

In Oman, the business is developing its position building on a long history of relationships with the Omani armed forces through the provision, support and upgrade of defence platforms and cyber security services. Business generated in Oman is executed through our relevant reporting segments.

MBDA is a leading global prime contractor of missiles and missile systems across the air, maritime and land domains.

Our strategy in action
Drive value and growth from our defence platforms and services

Supporting industrialisation in Saudi Arabia

The Kingdom of Saudi Arabia recently set out its Vision 2030 – ambitious plans to transform its economy and further develop thriving national industries. We are committed to supporting this agenda.

During 2016, there has been further capability and knowledge transfer on the Typhoon platform, and planning is well advanced for the transfer of other capabilities and work into our In-Kingdom partner companies. These partner companies include providers of training, supply chain and IT services, as well as an aircraft equipment and maintenance supplier and a firm specialising in modern electronics manufacturing, system integration, and repair and maintenance.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

Operational and strategic highlights

- BAE Systems celebrated 50 years in Saudi Arabia
- 11 Typhoon aircraft delivered on the Salam programme in the year
- Continued provision of support agreed under the Saudi British Defence Co-operation Programme to the Royal Saudi Air Force and Royal Saudi Naval Forces through to 2021, against which we have booked initial order intake in 2016
- BAE Systems Australia selected to provide maintenance, repair, overhaul and upgrade to support a range of F-35 Lightning II system components
- Awarded a contract for the Risk Mitigation Activity phase of the Land 400 vehicle competition in Australia
- Contracts totalling A$430m (£252m) awarded for sustainment and upgrade of Anzac Class frigates under the Warship Asset Management Alliance
- UK Ministry of Defence awarded MBDA a contract for additional Common Anti-air Modular Missiles
- MBDA signed two significant contracts in Qatar for naval air defence and coastal battery defence systems
- MBDA secured weapons package orders with India as part of agreed export contracts for Rafale aircraft

Financial performance

Financial performance measures as defined by the Group

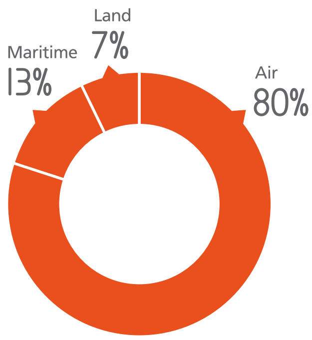
		2016	2015
Sales	KPI	**£3,943m**	£3,742m
Underlying EBITA	KPI	**£400m**	£335m
Return on sales		**10.1%**	9.0%
Operating business cash flow	KPI	**£435m**	£164m
Order intake[1]	KPI	**£6,175m**	£3,046m
Order backlog[1]		**£13.1bn**	£10.2bn

Financial performance measures defined in IFRS[2]

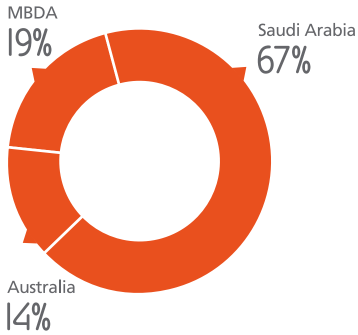
	2016	2015
Revenue	**£3,037m**	£2,957m
Operating profit	**£365m**	£299m
Return on revenue	**12.0%**	10.1%
Cash flow from operating activities	**£473m**	£193m

- Sales of £3.9bn were 5% up over 2015. The trading increase comes from the higher levels of support to the Salam Typhoon aircraft now in service and weapon volumes from MBDA.
- Underlying EBITA of £400m (2015 £335m) has moved the return on sales back above 10% (2015 9.0%). The 2015 result included charges totalling £53m in respect of the impairment and rationalisation taken in the Australian business.
- Operating business cash flow was strong at £435m (2015 £164m), although accelerated receipts from 2017 on Saudi support and the MBDA Qatar programme were major factors.
- Order backlog[1] increased to £13.1bn (2015 £10.2bn) as initial order intake was booked for the renewal of the five-year support contract in Saudi Arabia.

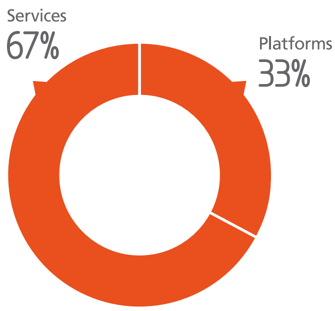
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



P06–07
Alternative performance measure definitions

Segmental performance
Platforms & Services (International)

Operational performance

Saudi Arabia

On the Salam Typhoon programme, 68 of the contracted 72 aircraft had been delivered at 31 December. Typhoon capability expansion is progressing to schedule.

The Typhoon support contracts are operating well, meeting all contractual metrics.

Through the Saudi British Defence Co-operation Programme, the business continues to support the operational capabilities of the Royal Saudi Air Force and Royal Saudi Naval Forces. The contract for Hawk aircraft signed in 2012 continues on schedule, with 14 aircraft delivered and accepted at 31 December. Manufacturing for the second batch of 22 aircraft, awarded in 2015, is progressing to schedule. Under this contract, we will undertake the final assembly of these aircraft in Saudi Arabia.

Under the Royal Saudi Naval Forces' Minehunter mid-life update programme, acceptance of the second ship was completed in the second half of the year. Work on the third and final ship is progressing to plan, with acceptance expected in the second half of 2017.

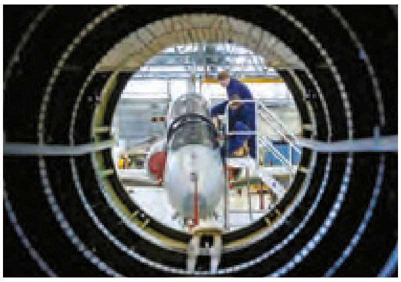
Agreement has been reached with the Saudi Arabian government for BAE Systems to continue to provide support services to the Royal Saudi Air Force and Royal Saudi Naval Forces under the Saudi British Defence Co-operation Programme for a further five years, against which we have booked initial order intake in 2016. Discussions with the UK government and the Saudi Arabian customer are under way to define the details of this follow-on contract.

Under the planned reorganisation of our portfolio of interests in a number of industrial companies in Saudi Arabia, Riyadh Wings Aviation Academy LLC has acquired a 4.1% shareholding in a Group subsidiary, Overhaul and Maintenance Company, and is expected to acquire a further interest up to a maximum of 49%. The reorganisation supports our strategy to expand the customer base of our In-Kingdom Industrial Participation programme, promoting training, development and employment opportunities in line with Vision 2030.

The Saudi Arabian In-Kingdom Industrial Participation programme continues to make progress. During 2016, there has been further capability and knowledge transfer on the Typhoon platform and planning is well advanced for the transfer of other capabilities and work into our In-Kingdom partner companies. All of these activities are aligned with our long-term industrialisation strategy, as well as the Saudi Arabian government's National Transformation Plan and Vision 2030.

Our strategy in action
Continue to win new international orders

Australian Hawk support contract



We provide support to the Royal Australian Air Force's (RAAF) Hawk fleet at its bases in Williamtown and Pearce. Working alongside the RAAF, we ensure that the aircraft are available for training when required and have continued to deliver significant savings. Since 2013, we have achieved all contract key performance indicators for deep maintenance of the fleet. In 2016, we expanded our long-standing relationship with the RAAF to include operational maintenance and secured an A$200m (£117m) contract, extending our support to 2020, and ensuring that Australia's combat pilots continue to receive the best training possible.

More online
baesystems.com

Australia

The consolidation of operating divisions announced in 2015, from three to two, was completed during the year.

We have continued to provide in-service support to the Navy's two Landing Helicopter Docks under a four-year support contract awarded in 2014. Final acceptance of these vessels is scheduled in 2017.

The fifth Anzac Class frigate to be modernised under the current Anti-Ship Missile Defence programme, HMAS Parramatta, has completed final sea trials and has been accepted into service by the Commonwealth. Completion of the upgrade programme is expected in 2017.

In April, the Australian government signed an agreement for the sustainment and upgrade of the Anzac Class frigates under the Warship Asset Management Alliance. We are a significant participant and the agreement underpins our engineering and complex project management capabilities. We were awarded contracts totalling A$430m (£252m) in the year.

In April, the Australian government announced that our Type 26 Global Combat Ship had been shortlisted as one of three designs for its SEA 5000 Future Frigate programme and, in August, a contract was signed with the Commonwealth to further refine the design as part of a competitive evaluation process.

In November, BAE Systems was chosen to provide maintenance, repair, overhaul and upgrade services to support a range of system components on the F-35 Lightning II aircraft. Our scope of work involves global sustainment services for life support components and sustainment services for the South Pacific region across avionics and digital mission systems and electrical systems components. This award follows our selection, in 2015, as the Pacific regional prime contractor to undertake airframe maintenance, repair, overhaul and upgrade.

In May, the Royal Australian Air Force celebrated its Hawk aircraft fleet achieving the significant milestone of more than 100,000 flying hours. We support the fleet as the systems integrator, including logistics, maintenance, repair, overhaul and upgrade. From July, our scope of work was expanded to include operational maintenance, a reflection of this successful long-term partnering arrangement.

In 2016, the government announced that we were one of two tenderers successfully down-selected on the Land 400 Phase 2 Combat Reconnaissance Vehicle programme.

We are engaged in discussions with the Australian government regarding the forward delivery schedule for the delayed JP 2008 Phase 3F programme for enhanced satellite communications services to the Australian Defence Force.

Oman
The Oman Typhoon and Hawk aircraft programme, being undertaken by Platforms & Services (UK), is on track for commencement of aircraft deliveries in 2017. Separately, we continue to fulfil our legacy industrial participation obligations in Oman through delivery of an agreed training and knowledge transfer programme.

MBDA
In 2015, the German government announced its intention to acquire a ground-based air defence system based upon the Medium Extended Air Defence System missile defence system being developed by MBDA in partnership with Lockheed Martin. MBDA has now submitted its proposal for the development of this system.

In a significant development for the Aster surface-to-air missile family, France and Italy have jointly launched development of the Aster 30 Block 1 NT (New Technologies) missile which will provide enhanced capabilities against the ballistic missile threat.

MBDA is responsible for the delivery of the majority of the UK's complex weapons requirements. During the year, a number of contracts have been awarded to MBDA, including a contract to supply Advanced Short-Range Air-to-Air Missiles (ASRAAM) for F-35 Lightning II aircraft, a development phase contract for SPEAR 3 (a multi-purpose stand-off strike weapon for the F-35 Lightning II aircraft), and a demonstration and manufacture contract for the supply of the Sea Ceptor air defence weapon system for the Type 26 frigate.

The UK Ministry of Defence awarded MBDA a contract for additional Common Anti-air Modular Missiles to support its land requirements.

The Meteor Beyond Visual Range Air-to-Air Missile achieved its most significant milestone to date during the Farnborough International Airshow in 2016 when it was officially declared in operational service on Swedish Air Force Gripen JAS 39 combat jets.

Two significant contracts were signed with Qatar, including the supply of Aster/VL Mica air defence systems and the Exocet MM40 Block 3 anti-ship missile for the Naval surface fleet, as well as a Missile Coastal Defence System.

MBDA has secured an aircraft weapons package contract from India and continues to pursue weapons package orders as part of export contracts for Typhoon and other aircraft platforms.

Looking forward

In the Kingdom of Saudi Arabia, following agreement of the budget for the next five years of the Saudi British Defence Co-operation Programme, we expect to sustain our long-term presence through delivering current programmes, further industrialisation and developing new business in support of the Saudi military forces. We are focused on our ongoing commitment to support the national objectives of local skills and technology, increasing employment and developing an indigenous defence industry, and will structure our business and portfolio of interests in Saudi Arabia to meet this long-term strategy.

In Australia, the business is now structured around long-term sustainment and upgrade activities and we are progressing further opportunities with the Australian government to provide leading defence build and support capabilities.

MBDA has a strong order book that underpins future growth built on the effective partnerships it has established with its domestic customers and recent export success. The business will look to further this domestic and export strategy in the air, maritime and land domains.

Corporate responsibility

Corporate responsibility is a key enabler for our business, supporting sustainable long-term performance by managing non-financial risks that can impact reputation and shareholder value.

Introduction

Our corporate responsibility programmes focus on:

- developing an inclusive, diverse workplace to drive innovation and performance (see page 22);
- instilling responsible behaviour to be a trusted partner (see page 55);
- supporting customer confidence in our business by continuously improving standards of safety for employees and those using our products (see page 56); and
- proactively managing the environmental impacts of our facilities and products to improve efficiencies and cost savings (see page 57).

We set global corporate responsibility priorities, which are enacted at a local level. These are incorporated into objectives and programmes for diversity and inclusion, business conduct, safety, and the environment.

Corporate responsibility in action
Continuously improving standards of safety

External recognition for health and safety performance

Naval Ships, part of our UK Maritime business, was awarded a Five Star Award in Occupational Health and Safety following a British Safety Council audit in December.

The audit involved an in-depth examination of our entire health and safety management systems and associated arrangements, focusing on key aspects of our approach to managing occupational health and safety. Naval Ships exceeded in four out of five of the best practice indicators, achieving 94%, which is rated as excellent and equates to the maximum five star award.

As a Five Star organisation, Naval Ships will be eligible to apply for the 2017 Sword of Honour award, which recognises the best of the best in health and safety management.

Trust and integrity

We aim to be recognised as a leader in business conduct. This helps us to earn and maintain stakeholder trust and sustain business success.

We continue to build a culture where our senior leaders and employees are empowered to make the right decisions and to know where to go for help. Our Code of Conduct sets out clear expectations on ethical conduct and we offer training and support to help people understand the right thing to do.

During 2016, we rolled out face-to-face ethics training that covered dilemmas based on real issues that employees have faced across the business. Employees also received additional training related to their specific role.

Our Ethics Officers are appointed across our business and provide face-to-face advice and support on how to understand policies, resolve issues and report concerns.

Employees also have access to our 24-hour Ethics Helpline to ask for support or report concerns anonymously. There were 1,121[1] calls to the Ethics Helpline in 2016, broadly consistent with the number of calls in 2015, and our anonymity rate compares favourably with peer companies. Almost half of the ethics contacts received are requests for guidance and advice. We encourage employees to contact us as early as possible when a potential incident can still be prevented by timely advice.

All enquiries reported to Ethics Officers and via the Ethics Helpline were reviewed and reported either to the Ethics Review Committee or, in BAE Systems, Inc., to the Ethics Review Oversight Committee.

Our governance framework sets out the way we do business and covers the products we make and export, and our relationships with business partners, including advisers and suppliers.

Our Responsible Trading Principles, Product Trading Policy and Pursuit of Export Opportunities Policy help employees to make informed decisions about the business opportunities we pursue and require evaluation and approval of trading risks.

Our policies and procedures require that all advisers are approved via our due diligence process and authorised by an external panel. Advisers with whom businesses have an ongoing relationship go through this process every two years.

We depend on suppliers to support our business and provide innovative and cost-effective products. Our relationships with suppliers are often long term due to the length of our product lifecycles, so we aim to build relationships with suppliers who share our values and who embrace standards of ethical behaviour consistent with our own. Our Procurement Policy specifically addresses ethical standards in our supply chain. We set our expectations for suppliers within our contracts and Supplier Principles – Guidance for Responsible Business, including standards on ethical conduct, health and safety, environment, and human rights.

We remain committed to respecting the human rights of our employees in the workplace and encourage our suppliers and business partners to adopt the same or similarly high standards of ethical behaviour. During 2016, we undertook work to understand our human rights impacts and this will continue into 2017. We have also responded to the UK Modern Slavery Act. Our statement can be found on baesystems.com.

We continue to work with peers across the defence industry to improve ethical standards. During 2016, we continued to participate in the International Forum on Business Ethical Conduct's Council and worked with the Institute of Business Ethics to set up a UK Defence Ethics Network.

2017 priorities

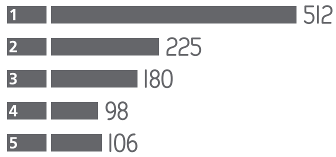
We will continue to build a culture of responsible behaviour by engaging employees in annual ethics training and supporting them in making the right decisions. We will also be reviewing and refreshing our Code of Conduct for launch in 2018.

Enquiries to Ethics Helpline[1]

Anonymity rate

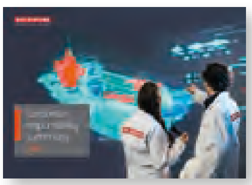
21% (2015 26%)

2016 enquiries to Ethics Helpline[1]



1 Guidance and advice
2 Employee relations and conduct
3 Management practices
4 Accounting charges practices
5 Other

Dismissals for reasons relating to unethical behaviour[1]



For further information, see our Corporate responsibility summary
baesystems.com/crsummary

1. See summary of Deloitte LLP assurance on page 57.

Corporate responsibility continued

Health and safety

The safety of our employees, and those who work on, or visit, our sites, remains a priority for the Company. Our safety culture and our customers demand extremely high standards for all aspects of health and safety. Many of our employees operate heavy equipment, work at height or do physically-demanding work in high-risk environments and confined spaces.

We aim to mitigate or manage safety risks by finding new ways to enhance safety standards, increase awareness and continually drive a strong safety culture. Managers across our businesses are supported by teams of health and safety specialists who provide expert advice, training and tools to put our safety policies into practice.

We use the Recordable Accident Rate to measure workplace injuries. This metric, along with the number of major injuries, is used to determine an element of executive bonus (see page 87). There was a 21% reduction in the Recordable Accident Rate in 2016, representing an improvement against target. In addition, there was a 26% reduction in the total number of major injuries recorded in the year as we continued to focus on reducing risk and embedding safety culture to drive improvement.

We want our employees to be healthy at work which depends on good health at home too. We operate wellbeing programmes to address this, which may include health risk assessments and campaigns to encourage employees to take responsibility for their health, including addressing risk factors for health problems such as heart disease, diabetes and cancer.

Our Employee Assistance Programme is a confidential service available to employees and includes support and advice on personal matters.

2017 priorities

We will continue to: drive towards a world-class level of safety performance; focus on the management and reduction of safety risk; and drive a strong safety culture through communication, awareness and visible leadership. We will target a 10% reduction in the Recordable Accident Rate.

Recordable Accident Rate (per 100,000 employees)[1]

KPI BONUS

2016	580
2015	732

Major injuries recorded[1]

BONUS

2016	39
2015	53

Corporate responsibility in action
Promoting good mental health in the workplace

Employee wellness and wellbeing

We are committed to reducing the stigma of mental ill-health in the workplace and we provide a range of support services and initiatives. During Mental Health Awareness Week in the UK, we raised awareness of the help the Group provides to employees through the services of occupational health, the Employee Assistance Programme and flexible working policies. In Australia, we support the 'R U OK?' suicide prevention campaign. This year, we held a series of 'R U OK?' events to encourage our employees to regularly reach out to and make time for other people. These included breakfasts, morning teas and mental health information sessions.

More online
baesystems.com

BONUS 5% of the UK executive directors' bonuses are based on the achievement of safety KPIs (see page 87).

1. See summary of Deloitte LLP assurance on page 57.

Resource efficiency

We are committed to minimising the environmental impact of our operations.

Resource efficiency is an important measure of business effectiveness at BAE Systems and is embedded within our Environment Policy. As a major manufacturer, our operations have an impact on the environment – from the energy and resources we use to the waste that we generate. Minimising this impact shrinks our environmental footprint and reduces our operating costs.

Each of our businesses sets annual targets to use resources as efficiently as possible with a focus on energy, water and waste.

We are improving energy efficiency and de-carbonising our energy supply to reduce greenhouse gas emissions. The nature of our business, with large-scale projects and fluctuations in orders, makes it challenging to set a global emissions reduction goal. We set energy targets at business level that contribute to an overall reduction.

The majority of our greenhouse gas emissions come from the energy we use across our facilities. The Group's total greenhouse gas emissions decreased by 4% in the 12 months to 31 October 2016.

We use our engineering expertise to improve resource efficiency and make our products more sustainable. We work to reduce environmental impacts at every stage of their lifecycle – from concept, design and manufacture through to use and disposal.

2017 priorities

We will continue to drive improvements in the management of materials and resources across all businesses.

Community investment

Globally, we and our employees, through the Community Investment programme, contributed more than £11m[1] during 2016 to local, national and international charities and not-for-profit organisations.

Deloitte LLP assurance

Deloitte LLP has provided limited assurance on the following performance indicators at Group level:

- Diversity – total employees split by gender and age;
- Ethics – employee and third-party enquiries to Ethics Helpline and dismissals for reasons relating to unethical behaviour;
- Safety – Recordable Accident Rate and the number of major injuries recorded;
- Environment – greenhouse gas emissions (total, and Scope 1, 2 and 3); and
- Community – total value of Community Investment programme donations.

More online

To see Deloitte LLP's unqualified assurance statement visit baesystems.com/deloitteassurancestatement

To see our Basis of Reporting 2016 visit baesystems.com/2016crdata

Greenhouse gas emissions data from 1 November 2015 to 31 October 2016 (tonnes CO_2e)

Combustion of fuel within BAE Systems facilities and vehicles (Scope 1)[1]

2016	579,880
2015	596,515

Electricity and steam purchased for BAE Systems use (Scope 2 – location-based)[1]

2016	571,859
2015	607,876

Business travel in non-BAE Systems vehicles (Scope 3)[1]

2016	146,511
2015	147,809

Total greenhouse gas emissions[1]

2016	1,298,250
2015	1,352,200

Total greenhouse gas emissions per employee[2]

2016	17
2015	18

Methodology

The greenhouse gas emissions data is reported in line with the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard 'Operational Control' approach, and emission factors for fuels and electricity are taken from the UK government's Department for Environment Food & Rural Affairs (DEFRA), published at www.ukconversionfactorscarbonsmart.co.uk/

The CO_2e associated with carbon dioxide, methane and nitrous oxide is reported. Greenhouse gas emissions associated with hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride are estimated to be immaterial to total emissions and are, therefore, not reported.

The principal record of the Group's worldwide facilities is its legal department's Global Property Database.

Greenhouse gas emissions are primarily calculated from energy consumption records reported via the Group's global environmental database. Where actual usage data is not available for facilities and residences within the Global Property Database, an estimated consumption is used based on the type of building.

Greenhouse gas emissions related to business travel include air travel data for the majority of the global business and rail data for business units operating in the UK and US. These data are taken from travel suppliers' procurement records.

Emissions from joint ventures and pension scheme properties not occupied by the Group are not included. Where a business or facility is acquired during a reporting year, it will be included in our reporting in the next full reporting year after the change.

The Scope 2 greenhouse gas emissions associated with the Greenhouse Gas Protocol 'market-based' method have been calculated as 638,772 tonnes CO_2e. Supplier-specific emission factors have been sought for our most significant operating regions, but were either deemed of insufficient quality to use at present or were unavailable. Therefore, in line with the Greenhouse Gas Protocol guidance, this figure has been calculated using residual-mix emission factors where available for our UK and US operations. In our other significant operating regions, residual-mix emission factors are either unavailable or within the margin of error of the standard grid average emission factor and, therefore, the latter has been used.

1. See summary of Deloitte LLP assurance above.
2. Excluding share of equity accounted investments.

How we manage risk

Effective management of risks and opportunities is essential to the delivery of the Group's strategic objectives and the creation of sustainable shareholder value.

Board

The Board has overall responsibility for determining the nature and extent of the risk it is willing to take, and ensuring that risks are managed effectively across the Group.

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

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

Audit Committee

The Audit Committee monitors the Group's key risks identified by the risk assessment processes and reports its findings to the Board twice a year. It is also responsible for reviewing in detail the effectiveness of the Group's system of internal control policies, and procedures for the identification, assessment and reporting of risk.

Corporate Responsibility Committee

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

Approach

The Group's Risk Management Policy is set out in the Operational Framework, the Group's detailed governance framework.

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

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

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

The Board has conducted a review of the effectiveness of the Group's systems of risk management and internal control processes, including financial, operational and compliance controls and risk management systems, in accordance with the UK Corporate Governance Code. The Company has developed a system of internal controls that was in place throughout 2016 and to the date of this report.

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

Financial and non-financial risks

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

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

Process

Businesses

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

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

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

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

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

Executive Committee

The key financial and non-financial risks identified by the businesses from the risk assessment processes are collated and reviewed by the Executive Committee to identify those issues where the cumulative risk, or possible reputational impacts, could be significant.

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

Principal risks

The Board has carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency and liquidity. Such risks have been identified as principal based on the likelihood of occurrence and the potential impact on the Group, and have been identified through the application of the policies and processes outlined above. These risks, together with details of how they are being mitigated and managed, are detailed on pages 60 to 63.

As a result of its assessment of the Group's principal risks, the Board has determined that the principal risks are consistent with the 2015 Annual Report.

P60
Principal risks

Risk management framework

Board
Overall responsibility for risk management

Monitoring

Audit Committee
Operational Assurance Statement Risk Register
Non-financial Risk Register

Corporate Responsibility Committee
Non-financial Risk Register

Monitoring and reporting

Monitoring and reporting

Monitoring and reporting

Executive Committee
Operational Assurance Statement Risk Register
Non-financial Risk Register

Monitoring and reporting

Businesses

Integrated Business Plan – Core Business Process*
Annual long-term strategy and five-year plan for each business

Operational Assurance Statement – Mandated Policy*
Six-monthly management self-assessment of compliance with the Operational Framework and summary of key risks

Chief Executive's Business Review – Core Business Process*
Quarterly top-level review of the key operational, financial and non-financial performance issues within the business, and significant forthcoming bids and events

Quarterly Business Review – Core Business Process*
Quarterly management review of the performance of each of the Group's businesses against their objectives, measures and milestones

Lifecycle Management Contract Review – Core Business Process*
Monthly management review of project performance and issues to ensure that appropriate decisions and actions are taken

Monitoring and reporting

Business Risk
Risk Management Policy – Mandated Policy*

1. Identification
Financial and non-financial risks recorded in risk registers

2. Analysis
Risks analysed for impact and probability to determine gross exposure

3. Evaluation
Risk exposure reviewed and risks prioritised

4. Mitigation
Risk owners identified and action plans implemented
Robust mitigation strategy subject to regular and rigorous review

*As defined in the Group's Operational Framework.

P67
Operational Framework

Principal risks

Risks are identified based on the likelihood of occurrence and the potential impact on the Group. The Group's principal risks are identified below, together with a description of how we mitigate those risks.

1. Defence spending

The Group is dependent on defence spending.

Description

In 2016, 91% of the Group's sales were defence-related.

Defence spending by governments can fluctuate depending on political considerations, budgetary constraints, specific threats and movements in the international oil price.

There have been constraints on government expenditure in a number of the Group's principal markets, in particular in the US and UK. The results of the 2016 elections in the US and EU referendum in the UK have led to a period of uncertainty.

Impact

Lower defence spending by the Group's major customers could have a material adverse effect on the Group's future results and financial condition.

Mitigation

The business is geographically spread across US, UK and international defence markets:

– In the US, following the two-year Bipartisan Budget Act signed in 2015, the defence market outlook is improving with encouraging signs of a return to growth in defence budgets.
– In the UK, the Spending Review in 2015 outlined a 3.1% real-term increase to the defence budget by 2020 as part of the commitment to spend 2% of Gross Domestic Product on defence.
– In Saudi Arabia, regional tensions continue to dictate that defence remains a high priority.

The diverse product and services portfolio is marketed across a range of defence markets. BAE Systems benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia.

BAE Systems has a growing portfolio of commercial businesses, including commercial avionics and the commercial areas of the Applied Intelligence business. Sales in commercial markets represented 9% of the Group's sales in 2016.

2. Government customers

The Group's largest customers are governments.

Description

The Group has long-standing relationships and security arrangements with a number of its government customers, including its three largest customers, the governments of the US, UK and Saudi Arabia, and their agencies. It is important that these relationships and arrangements are maintained.

In the defence and security industries, governments can typically modify contracts for their convenience or terminate them at short notice. Long-term US government contracts, for example, are funded annually and are subject to cancellation if funding appropriations for subsequent periods are not made. Governments also from time to time review their terms of trade and underlying policies and seek to impose such new terms and policies when entering into new contracts.

The Group's performance on its contracts with some government customers is subject to financial audits and other reviews which can result in adjustments to prices and costs.

Impact

Deterioration in the Group's principal government relationships resulting in the failure to obtain contracts or expected funding appropriations, adverse changes in the terms of its arrangements with those customers or their agencies, or the termination of contracts could have a material adverse effect on the Group's future results and financial condition.

Mitigation

Government customers have sophisticated procurement and security organisations with which the Group can have long-standing relationships with well-established and understood terms of business.

In the event of a customer terminating a contract for convenience, the Group would typically be paid for work done and commitments made at the time of termination.

3. International markets

The Group operates in international markets.

Description	Impact	Mitigation
BAE Systems is an international company conducting business in a number of regions, including the US and the Middle East.	The occurrence of any such events could have a material adverse effect on the Group's future results and financial condition.	The Group has a balanced portfolio of businesses across a number of markets internationally. The Group benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia.
The risks of operating in some countries include: political changes impacting the business environment; economic downturns, political instability and civil disturbances; changes in government regulations and administrative policies; the imposition of restraints on the movement of capital; the introduction of burdensome taxes or tariffs; and the inability to obtain or maintain the necessary export licences.		The Group's policy is to hedge all material firm transactional currency exchange rate exposures.
The Group is exposed to volatility arising from movements in currency exchange rates, particularly in respect of the US dollar, euro, Saudi riyal and Australian dollar. There has been volatility in currency exchange rates in the period since the announcement of the results of the 2016 elections in the US and EU referendum in the UK.		The Group's contracts are often long-term in nature and, consequently, it may be able to mitigate these risks over the terms of those contracts.
Judicial Review proceedings into the process followed by the UK government in granting defence export licences to the Kingdom of Saudi Arabia are under way. A judgment is expected in the near future, which may impact the granting of export licences for the sale of arms to the Kingdom. The conclusion of the proceedings is awaited.		Political risk insurance is held in respect of export contracts not structured on a government-to-government basis.
		BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying restrictions that could adversely impact the Group's activities, including export control requirements.

4. Competition in international markets

The Group's business is subject to significant competition in international markets.

Description	Impact	Mitigation
The Group's business plan depends upon its ability to win and contract for high-quality new programmes, an increasing number of which are expected to be in markets outside the US and UK.	The Group's business and future results may be adversely impacted if it is unable to compete adequately and obtain new business in the markets in which it operates.	The Group has an international, multi-market presence, a balanced portfolio of businesses, leading capabilities and a track record of delivery on its commitments to its customers.
The Group is dependent upon US and UK government support in relation to a number of its business opportunities in export markets.		The Group continues to invest in research and development, and to reduce its cost base and improve efficiencies, to remain competitive.
		In the UK, export contracts can be structured on a government-to-government basis and government support can also involve military training, ministerial support for promotional activities and financial support through UK Export Finance. In the US, most of the Group's defence export sales are delivered through the Foreign Military Sales process, under which the importing government contracts with the US government.

Principal risks
continued

5. Laws and regulations

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

Description	Impact	Mitigation
The Group operates in a highly-regulated environment across many jurisdictions and is subject, without limitation, to regulations relating to import-export controls, money laundering, false accounting, anti-bribery and anti-boycott provisions. It is important that the Group maintains a culture in which it focuses on embedding responsible business behaviours and that all employees act in accordance with the requirements of the Group's policies, including the Code of Conduct, at all times. Export restrictions could become more stringent and political factors or changing international circumstances could result in the Group being unable to obtain or maintain necessary export licences.	Failure by the Group, or its sales representatives, marketing advisers or others acting on its behalf, to comply with these regulations could result in fines and penalties and/or the suspension or debarment of the Group from government contracts or the suspension of the Group's export privileges, which could have a material adverse effect on the Group. Reduced access to export markets could have a material adverse effect on the Group's future results and financial condition.	BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying restrictions that could adversely impact the Group's activities. Internal and external market risk assessments form an important element of ongoing corporate development and training processes. A uniform global policy and process for the appointment of advisers engaged in business development is in effect. The special compliance officer, appointed pursuant to commitments concerning ongoing regulatory compliance made in the course of the 2011 settlement with the US Department of State, concluded his monitorship in May 2014 and, at the invitation of BAE Systems, agreed to remain in a limited capacity for a limited further period of time.

6. Contract risk and execution

The Group has many contracts, including a small number of large contracts and fixed-price contracts.

Description	Impact	Mitigation
In 2016, 49% of the Group's sales were generated by its 15 largest programmes. At 31 December 2016, the Group had five programmes with order backlog in excess of £1bn. A significant portion of the Group's revenue is derived from fixed-price contracts. Actual costs may exceed the projected costs on which the fixed prices are agreed and, since these contracts can extend over many years, it can be difficult to predict the ultimate outturn costs. It is important that the Group maintains a culture in which it delivers on its projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner.	The inability of the Group to deliver on its contractual commitments, the loss, expiration, suspension, cancellation or termination of any one of its large contracts or its failure to anticipate technical problems or estimate accurately and control costs on fixed-price contracts could have a material adverse effect on the Group's future results and financial condition.	Contract-related risks and uncertainties are managed under the Group's mandated Lifecycle Management process. A new leadership development programme for project directors is being deployed across the Group, covering the leadership competencies required to manage complex projects containing significant levels of risk and uncertainty. A significant proportion of the Group's largest contracts are with the UK Ministry of Defence. In the UK, development programmes are normally contracted with appropriate levels of risk being initially held by the customer and contract structures are used to mitigate risk on production programmes, including where the customer and contractor share cost savings and overruns against target prices. The Group has a well-balanced spread of programmes and significant order backlog which provides forward visibility. The Group has limited exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. Robust bid preparation and approvals processes are well established throughout the Group, with decisions required to be taken at the appropriate level in line with clear delegations of authority.

7. Contract cash profiles

The Group is dependent on the award timing and cash profile of its contracts.

Description	Impact	Mitigation
The Group's profits and cash flows are dependent, to a significant extent, on the timing of, or failure to receive, award of defence contracts and the profile of cash receipts on its contracts.	Amounts receivable under the Group's defence contracts can be substantial and, therefore, the timing of, or failure to receive, awards and associated cash advances and milestone payments could materially affect the Group's profits and cash flows for the periods affected, thereby reducing cash available to meet the Group's cash allocation priorities, potentially resulting in the need to arrange external funding and impacting its investment grade credit rating.	The Group's balance sheet continues to be managed conservatively in line with its policy to retain an investment grade credit rating and to ensure operating flexibility. The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet its operational needs and maintain adequate headroom.

8. Pension funding

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

Description	Impact	Mitigation
In aggregate, there is an actuarial deficit between the value of the projected liabilities of the Group's defined benefit pension schemes and the assets they hold. The deficits may be adversely affected by changes in a number of factors, including investment returns, long-term interest rate and price inflation expectations, and anticipated members' longevity. There has been volatility in US and UK bond yields, in particular in the period since the announcement of the results of the 2016 elections in the US and EU referendum in the UK. The reduction in discount rates in 2016 has increased the Group's share of the accounting net pension deficit.	Increases in pension scheme deficits may require the Group to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet the Group's other cash allocation priorities.	In the UK, new employees have been offered membership of defined contribution rather than defined benefit schemes since April 2012 and, in the US, employees have not accrued salary-related benefits in defined benefit schemes since January 2013. In 2014, deficit recovery plans, the longest of which runs until 2026, were agreed with the trustees of the Group's UK pension schemes following triennial funding valuations. The next UK triennial funding valuations will commence in April 2017 and, in conjunction with the trustees of the schemes and other stakeholders, the Group will be looking at various options with a focus on the longer-term view.

9. Information technology security

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

Description	Impact	Mitigation
The security threats faced by the Group include threats to its information technology infrastructure, unlawful attempts to gain access to its proprietary or classified information and the potential for business disruptions associated with information technology failures.	Failure to combat these risks effectively could negatively impact the Group's reputation among its customers and the public, cause disruption to its business operations, and could result in a negative impact on the Group's future results and financial condition.	The Group has a broad range of measures in place, including appropriate tools and techniques, to monitor and mitigate this risk.

10. People

The Group's strategy is dependent on its ability to recruit and retain people with appropriate talent and skills.

Description	Impact	Mitigation
Delivery of the Group's strategy and business plan is dependent on its ability to compete to recruit and retain people with appropriate talent and skills, including those with innovative technological capabilities. The Group's business plan is targeting an increasing level of business in international export markets outside the US and UK. It is important that the Group recruits and retains management with the necessary international skills and experience in the relevant jurisdictions.	The loss of key employees or inability to attract the appropriate people on a timely basis could adversely impact its ability to deliver its strategy, meet the business plan and, accordingly, have a negative impact on the Group's future results and financial condition.	The Group recognises that its employees are key to delivering its strategy and business plan, and focuses on developing the existing workforce and hiring talented people to meet current and future requirements. The Group has well-established graduate recruitment and apprenticeship programmes and, in order to maximise the contribution that its workforce can make to the performance of the business, has an effective through-career capability development programme. In order to seek to maximise its talent pool, the Group is committed to creating a diverse and inclusive environment for its employees. BAE Systems continues to reinforce its ethics programme globally, driving the right behaviours by supporting employees in making ethical decisions and embedding responsible business practices.

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

Strategic report

The Strategic report was approved by the board of directors on 22 February 2017.

David Parkes
Company Secretary

Chairman's governance letter

Contents

Dear Shareholders,

During the course of the year, the Financial Reporting Council (FRC) published its report on Corporate Culture and the Role of Boards. The report contained key observations about the value of culture in driving the right behaviours in the boardroom and at all levels in the company. We were pleased to see that the report included a case study on BAE Systems, illustrating the work we had undertaken over a number of years to foster high levels of personal trust between trade unions and the Company's senior leadership. As part of this year's Board evaluation, we have asked Board members to reflect on the questions asked in the FRC's report concerning corporate culture and provide their thoughts on what they see within BAE Systems. In 2017, we will be using the output from this to guide the Board in its further consideration of this important governance matter.

We welcomed the FRC's report and the principles of stakeholder engagement, directors' duties and the importance of corporate integrity and responsible behaviour that it outlined.

Towards the end of 2016, there was another important governance publication, with the UK government publishing a wide-ranging Green Paper on Corporate Governance Reform. Both documents quote in full the basic duty of a company director as detailed in Section 172 of the Companies Act.

In summary, the duty is to promote the success of the company and, in doing so, have regard to, amongst other matters, the long-term consequences of any decisions, the interests of employees and other stakeholders, and the desirability of maintaining high standards of business conduct. As required by the Companies Act, this Annual Report informs shareholders how the directors have performed this duty.

Governance highlights

- Charles Woodburn recruited during 2016 and the Board has announced that he will succeed Ian King as Chief Executive with effect from 1 July 2017
- Elizabeth Corley joined the Board as a non-executive director
- A review of the Directors' remuneration policy completed by the Remuneration Committee – following engagement and discussion with the Company's principal shareholders. The new policy will be put to this year's Annual General Meeting (AGM) for approval
- Auditor re-tender initiated by the Audit Committee, which will result in new auditors being proposed for appointment at the 2018 AGM
- A new programme of informal meetings created, enabling non-executive directors and senior executives below the Board to meet and help directors develop their knowledge of the Company's management resources and business issues
- An externally-facilitated Board performance evaluation completed during the year and a number of actions agreed based on the findings

Board evaluation – development areas

- Succession planning – greater Board engagement in executive development and succession planning, including greater visibility of high-potential individuals.
- Board composition – continue the non-executive succession planning activity with a view to recruiting an additional director.
- Induction process – produce a new induction manual for newly-appointed directors.
- Board meetings and papers – review the Board's annual schedule of meetings in the interests of efficient use of time, travel and Board engagement. Continue to improve the balance of detail, overview and analysis provided in Board papers.

The evaluation was undertaken by Independent Board Evaluation, who have no other connection with the Company.

In particular, you will find on page 66 an outline of our governance structure, including how the Board sets the values, behavioural expectations, policies and processes that guide all that we do in BAE Systems – and also how the Board maintains oversight over performance and compliance with these delegated requirements. As our Chief Executive tells all employees, "It's not just about what we do, but how we do it.".

Achieving high standards of corporate governance is an intrinsic part of the Board's agenda and, to that end, we completed a wide-ranging externally-facilitated evaluation of Board performance during the year.

The review reported very favourably on Board member attitude, engagement and contribution, and on the processes, practices and principles employed by the Company. A summary of the areas for development agreed by the Board is shown above.

We have recently completed the internal performance evaluation for 2017, which will focus on the areas recommended for improvement in 2016 and, as mentioned above, any actions necessary in response to the FRC's report on culture.

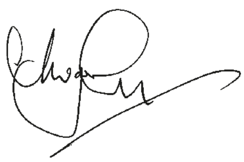
In parallel with an independent appraisal of Board performance, from time to time we commission an independent survey of our shareholders' views and perceptions of the performance of the Company. This document is shared with all Board members as a supplement to the updates provided by senior executive Board members. In addition, as Chairman, I consult with our large shareholders to ensure they have a full understanding of our strategy and I and the Board have received direct feedback on their views on the Company, its performance and governance.

My contact is supplemented by independent meetings held by the Chairman of the Remuneration Committee with specific reference to our pay policy and reward structures. Of course, as required by the UK Corporate Governance Code, shareholders have access to the Senior Independent Director if there are concerns that cannot be resolved through the normal Chairman or Chief Executive channels.

As a Board, we are committed to the highest standards of behaviour, transparency and open discussion, together with diversity of opinion, experience, background and gender.

By adopting this approach, and regular engagement and involvement with all our stakeholders, the Board believes that it is best placed to align its policies and practices in keeping with the required governance standards of the day.

The following report details how the Board has applied the UK Corporate Governance Code principles in the conduct of our business during the year.



Sir Roger Carr Chairman

Board governance

Shareholders

Approximately 100,000 individual, corporate and employee shareholders who are invited to meet at least annually (in person or by proxy) and exercise their stewardship voting rights on the basis of one share/one vote.

Annual General Meeting
Shareholders vote on key governance matters, including the re-election of directors, their remuneration, the payment of dividends and the appointment of the auditors.

Shareholder relations
The Chief Executive and Group Finance Director meet the Company's principal shareholders on a regular basis. Separately, the Chairman maintains regular contact with the Company's principal shareholders on governance matters and ensures that all directors are aware of their views.

Board

Currently comprising 11 directors who meet regularly and make decisions on a collective basis. The directors have a legal duty to promote the success of the Company.

The Board has adopted a governance structure based on the UK Corporate Governance Code (the Code). This is detailed in the Operational Framework (see opposite), which delegates matters to employees in a manner that has been designed to provide ongoing oversight of performance and adherence to policies and behavioural expectations.

Board composition

The Board consists of executive and independent non-executive directors, plus a non-executive chairman who was independent in accordance with the Code on his appointment.

The non-executive directors constructively challenge and help develop proposals on strategy. They also scrutinise the performance of management in meeting agreed goals and objectives, and satisfy themselves as to the integrity of financial information, and that systems of risk management are robust and defensible. In addition, they set the remuneration of the executive directors and oversee board succession planning.

Chairman
Responsible for leading the Board and ensuring that it discharges its duties efficiently.

Chief Executive
Responsible for the implementation and delivery of the strategy agreed by the Board.

Senior Independent Director
Acts as a sounding board for the Chairman and acts as an intermediary for the other directors as necessary.

Company Secretary
Responsible to the Board for ensuring that Board procedures are complied with. Through the Chairman, he is responsible for ensuring that directors are supplied with information in a timely manner.

Delegated authority

Oversight of performance and compliance with the Operational Framework

Delegation through committee terms of reference

Reporting, as appropriate, to the Board on matters considered and agreed

Board committees

The membership of the principal board committees (see below) solely comprises non-executive directors. They provide leadership, scrutiny and oversight over key governance areas.

P72 Audit Committee

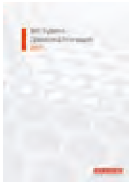
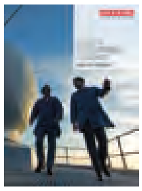
P76 Corporate Responsibility Committee

P78 Nominations Committee

P79 Remuneration Committee

Operational Framework

The Board has put in place a detailed governance framework, the Operational Framework. It sets out how we do business across BAE Systems and encapsulates our values, policies and processes, together with clear levels of delegated responsibility aimed at ensuring that all of our employees and businesses act in a clear, accountable and consistent manner.

How we work

The processes and policies in the Operational Framework set out the principles of good governance which, together with our culture, guide our work and behaviour in support of the strategy set in our Group strategic framework (see page 16). Here we set out the values that we ask all our employees to demonstrate in their day-to-day work, wherever they are in the world. We also confirm our commitment to Total Performance which defines how we achieve success based on Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour.

Organisation

From the Board downwards, we set out how we are organised and the responsibilities of the Board, the Chairman, the Chief Executive, the Executive Committee, our Functional Councils (such as Engineering, Human Resources and Procurement) and the senior executives charged with running our businesses.

Governance

The UK Corporate Governance Code's (the Code) principles are embedded in the Operational Framework and its policies and processes underpin all the disclosures made by the Board pursuant to Code provisions.

How we conduct our business is fundamental to the success of BAE Systems. The Operational Framework sets out our approach and the standards to which we adhere. It includes the following:

Code of Conduct
Sets the standards to which we all work.

Responsible Trading Principles
We do not compromise on the way we do business and here we mandate a principles-based approach to our business activity.

Internal controls
These are the controls that apply to all our businesses and provide assurance regarding:

- the reliability and integrity of information;
- compliance with policies, processes, laws, regulations and contracts;
- the safeguarding of assets and protection against fraud; and
- the economical and efficient use of resources.

Operational Assurance Statement (OAS)
This key governance process requires that a return is completed every six months by each operational and functional business head, reporting their formal view against such matters as compliance with law and regulation, ethical business conduct, financial controls, risk management, compliance with business planning processes, health and safety, conflicts of interest, delegated authorities, appointment of advisers and product safety. There is a separate OAS process for our joint ventures. Our Internal Audit function owns the OAS process. It is managed independently from management functions with the Internal Audit Director being responsible to the Audit Committee and reporting directly to the Chief Executive.

Risk framework
This is how we identify, analyse, evaluate and mitigate risk (see page 58).

Workplace and operational environment
This covers how we expect our people to be managed and the obligations placed on us all concerning avoiding conflicts of interest, anti-bribery, and managing the security of our people, information and other assets.

Delegated authorities
As part of a robust system of internal controls, the Board has delegated certain authorities to executive management. Delegation is subject to financial limits and other restrictions, above which matters must be referred to the Board.

Core business processes
These core business processes are mandated by the Operational Framework and designed to ensure consistent planning, reporting and review of business performance across all businesses:

IBP
(Integrated Business Planning)
Approved by the Board annually, creates a consistent approach to strategic planning, aligning resources with the delivery of forecast financial performance and strategic objectives.

LCM
(Lifecycle Management Policy)
How we plan and manage the execution of all projects above a certain minimum level, providing decision gate reviews at key stages from initial opportunity to final closure.

M&A
(Mergers & Acquisitions Policy)
A structured approach to mergers, acquisitions and disposals.

TPL
(Total Performance Leadership)
A set of people-related activities that help to identify, select, manage and reward leaders, and facilitates succession planning.

Board of directors

Chairman

Sir Roger Carr
Chairman

Appointed to the Board: 2013 **Nationality:** UK

Skills, competence and experience
Having joined the Board in 2013, Sir Roger was appointed Chairman in 2014. He is an experienced company chairman with a wealth of knowledge gained across a number of business sectors. He currently serves as vice chairman of the BBC Trust, a position he has held since March 2015.

With over two decades of boardroom experience, Sir Roger has a deep understanding of corporate governance and what is required to lead an effective board.

Prior to joining BAE Systems, Sir Roger was Chairman of Centrica plc and Deputy Chairman of the Court of the Bank of England. In the past, he has also served as chairman of Thames Water plc, Cadbury plc, Chubb and Mitchells & Butlers plc. He has been active in representing UK business having previously served as President of the CBI and as a member of the Prime Minister's Business Advisory Group. He was a member of the Higgs Committee on Corporate Governance, which assisted in further developing the UK Corporate Governance Code.

Other appointments
A senior adviser to Kohlberg Kravis Roberts, a fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, an honorary fellow of the Institute of Chartered Secretaries and Administrators, and a visiting fellow to the Saïd Business School, Oxford.

Other past appointments
Chief Executive, Williams plc.

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

Executive directors

Ian King
Chief Executive

Appointed to the Board: 2007 **Nationality:** UK

Skills, competence and experience
Ian was appointed as Chief Executive in 2008 having been originally appointed to the Board as Chief Operating Officer, UK and Rest of the World. He will retire on 30 June 2017. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Prior to the BAe/MES merger, he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems.

Other appointments
Non-executive director of Schroders plc.

Other past appointments
Non-executive director and senior independent director of Rotork plc.

Committee membership
Non-Executive Directors' Fees Committee.

Charles Woodburn
Chief Operating Officer

Appointed to the Board: 2016 **Nationality:** UK

Skills, competence and experience
Charles joined BAE Systems in May 2016 as Chief Operating Officer. He will succeed Ian King as Chief Executive with effect from 1 July 2017. Prior to joining the Company, he spent over 20 years in the oil and gas industry, holding a number of senior management positions in the Far East, Australia, Europe and the US. He joined the Company from the oilfield services business, Expro Group, where he served as Chief Executive Officer. Prior to that, he spent 15 years with Schlumberger Limited.

Other past appointments
Non-executive director of Seadrill Limited.

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

Appointed to the Board: 2014 **Nationality:** US

Skills, competence and experience
Appointed to the Board on 1 February 2014 as President and Chief Executive Officer of BAE Systems, Inc., Jerry is an experienced US executive who has worked in the national security, technology and aerospace industry for over 30 years. Most recently, he served as executive vice president and corporate vice president of General Dynamics' Information Systems and Technology Group. Earlier in his career, he spent almost a decade as an acquisition official at the US Department of Defense.

Other appointments
Non-executive director of Aero Communications, Inc.

Committee membership
Non-Executive Directors' Fees Committee.

Peter Lynas
Group Finance Director

Appointed to the Board: 2011 **Nationality:** UK

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

Other appointments
Non-executive director of SSE plc and chairman of its audit committee.

Non-executive directors

Elizabeth Corley CBE
Non-executive director

Appointed to the Board: 2016 **Nationality:** UK

Skills, competence and experience
Elizabeth brings investor, governance and boardroom experience to the Board. She is currently non-executive vice-chair of Allianz Global Investors, and a non-executive director of Pearson plc and the UK Financial Reporting Council.

She served as Chief Executive Officer of Allianz Global Investors, initially for Europe then globally, from 2005 to 2016. Prior to that, she worked for Merrill Lynch Investment Managers. She is a governor of the CFA Institute and a trustee of the British Museum.

Elizabeth is active in representing the investment industry and developing standards within it. She is a member of the FICC Market Standards Board, the European Securities and Markets Authority's stakeholder group and of the advisory council of TheCityUK. Elizabeth is also an acclaimed writer and member of the Royal Society of Arts.

Other appointments
Chair of the advisory group to the UK government on social impact investing.

Committee membership
Nominations Committee and Remuneration Committee.

Harriet Green OBE
Non-executive director

Appointed to the Board: 2010 **Nationality:** UK

Skills, competence and experience
Harriet is a transformative business leader with international operational and boardroom experience. She is currently General Manager of Watson Customer Engagement, Watson Internet of Things and Education at IBM.

Harriet has extensive global business leadership experience. She previously served as Chief Executive Officer and executive director of Thomas Cook plc. Prior to that, she was Chief Executive Officer and executive director of Premier Farnell plc. Previously, she was also a non-executive director of Emerson Electric Co.

In 2016, she won the Women in Technology Institute Award and, in 2014, she received the Veuve Clicquot Business Woman Award.

Other appointments
Member of the British Chambers of Commerce's International Advisory Council.

Other past appointments
Member of the Prime Minister's Business Advisory Group.

Committee membership
Corporate Responsibility Committee and Nominations Committee.

Chris Grigg
Non-executive director

Appointed to the Board: 2013 **Nationality:** UK

Skills, competence and experience
As chief executive of a FTSE 100 company, Chris brings management and boardroom experience to the Board. He is currently Chief Executive of The British Land Company PLC, a position he has held since 2009.

Chris has more than 30 years' experience in the banking and real estate industries. Prior to joining British Land, he was Chief Executive of Barclays Commercial Bank. Before that, he was a partner at Goldman Sachs.

Other appointments
Member of the executive board of the European Public Real Estate Association and the board of the British Property Federation.

Committee membership
Corporate Responsibility Committee and Nominations Committee.

Paula Rosput Reynolds
Non-executive director

Appointed to the Board: 2011 **Nationality:** US

Skills, competence and experience
An experienced company director in both the UK and North America, Paula is currently Chief Executive Officer and President of the business advisory group PreferWest LLC, and a non-executive director of BP p.l.c., CBRE Group, Inc. and TransCanada Corporation.

Starting her career as an economist, she spent over 20 years in the energy sector, culminating in her appointment as President and Chief Executive Officer of AGL Resources in 2002. She served as President and Chief Executive Officer of Safeco Corporation before becoming Vice Chairman and Chief Restructuring Officer of American International Group, overseeing its divestiture of assets and serving as chief liaison with the Federal Reserve Bank of New York.

She received the National Association of Corporate Directors National Lifetime Achievement Award in 2014.

Other past appointments
Non-executive director of Coca-Cola Enterprises Inc., Anadarko Petroleum Corporation, Delta Air Lines Inc., Air Products and Chemicals Inc., and Siluria Technologies, Inc.

Committee membership
Chairman of the Remuneration Committee, and member of the Audit Committee and Nominations Committee.

Nick Rose
Non-executive director and Senior Independent Director

Appointed to the Board: 2010 **Nationality:** UK

Skills, competence and experience
Nick brings to the Board considerable financial expertise and boardroom experience. He is currently Chairman of Williams Grand Prix Holdings PLC, and a non-executive director and senior independent director of BT Group plc.

Nick was Chief Financial Officer of Diageo plc for over ten years until 2010. In this role, he was responsible for supply, procurement, strategy and IT on a global basis. His financial experience was developed during his time as group treasurer and group controller at Diageo, and also in his earlier career at Ford Finance. He is a former Chairman of the engineering technology company Edwards Group Limited.

Other appointments
Adviser to CCMP Capital Advisors, LLC and non-executive chairman of Loch Lomond Group.

Other past appointments
Non-executive director of Moët Hennessy SNC and Scottish Power plc.

Committee membership
Chairman of the Audit Committee, and member of the Nominations Committee and Remuneration Committee.

Ian Tyler
Non-executive director

Appointed to the Board: 2013 **Nationality:** UK

Skills, competence and experience
Ian brings considerable financial and long-term international contracting experience to the Board. He is currently chairman of two UK listed companies, Bovis Homes Group PLC and Cairn Energy plc.

Having qualified as a chartered accountant, Ian subsequently held a number of senior finance and operational positions within industrial companies before being appointed Finance Director of Balfour Beatty plc in 1996. He was subsequently appointed Chief Executive, a position he stepped down from in 2013.

Other appointments
Chairman of AWE Management Limited.

Other past appointments
Non-executive director of Mediclinic International plc, Cable & Wireless Communications Plc and VT Group plc.

Committee membership
Chairman of the Corporate Responsibility Committee, and member of the Audit Committee and Nominations Committee.

Board information

Membership

	Committee membership	Nationality	Date of appointment to the Board	Date current term ends	Current term as director
Sir Roger Carr Chairman	N		2013[1]	2020	Second
Elizabeth Corley Non-executive director	N R		2016	2019	First
Harriet Green Non-executive director	C N		2010	2019	Third
Chris Grigg Non-executive director	C N		2013	2019	Second
Paula Rosput Reynolds Non-executive director	A N R		2011	2017	Second[2]
Nick Rose Non-executive director and Senior Independent Director	A N R		2010	2019	Third
Ian Tyler Non-executive director	A C N		2013	2019	Second

The average length of appointment of non-executive members of the Board (as at 31 December 2016) was 4.3 years.

	Committee membership	Nationality	Date of appointment to the Board	Date current term ends	Current term as director
Ian King Chief Executive			2007		
Peter Lynas Group Finance Director			2011		
Jerry DeMuro President and Chief Executive Officer of BAE Systems, Inc.			2014		
Charles Woodburn Chief Operating Officer			2016		

The average length of appointment of executive members of the Board (as at 31 December 2016) was 4.8 years.

Chairman
Non-executive director
Executive director

Committee chair
A Audit Committee
N Nominations Committee

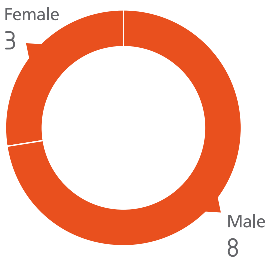
C Corporate Responsibility Committee
R Remuneration Committee

Attendance

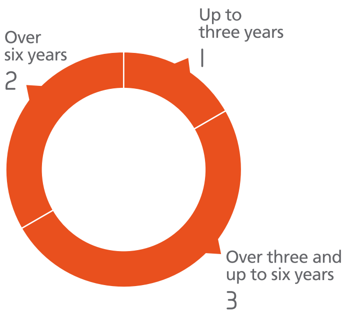
Individual directors' attendance at meetings of the Board and its committees in 2016

	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Sir Roger Carr	11/11	–	–	3/3	–
Elizabeth Corley	11/11	–	–	3/3	5/5
Jerry DeMuro	10/11	–	–	–	–
Harriet Green	9/11	–	4/4	3/3	–
Chris Grigg	11/11	–	3/4	3/3	1/1
Ian King	11/11	–	–	–	–
Peter Lynas	9/11	–	–	–	–
Paula Rosput Reynolds	9/11	5/5	–	3/3	6/6
Nick Rose	10/11	5/5	–	3/3	5/6
Ian Tyler	11/11	5/5	4/4	3/3	–
Charles Woodburn	5/5	–	–	–	–

Diversity – Board



Tenure – independent non-executive directors



1. Sir Roger Carr joined the Board in October 2013 and was appointed as Chairman in February 2014.
2. It has been agreed that Paula Rosput Reynolds will serve a third term with effect from 1 April 2017.

Governance disclosures

UK Corporate Governance Code (the Code) Compliance

The Company was compliant with the provisions of the Code throughout 2016 and the Board has applied its principles in its governance structure and operations. The following statements are made in compliance with the Code.

Risk management and internal control statement

The Board is responsible for the Company's risk management and internal control systems. It has delegated responsibility for reviewing in detail the effectiveness of these systems to the Audit Committee, which reports to the Board on its findings so that all directors can take a view on the matter.

An overview of the processes used to identify, evaluate and manage the principal risks can be found on pages 58 and 59. These processes are an integral part of our governance framework, the Operational Framework, details of which can be found on page 67. The Operational Framework mandates the Operational Assurance Statement process, which is owned by the Company's Internal Audit function and is one of the principal processes used by the Board in monitoring the effectiveness of control systems.

The risk management and internal control systems detailed in the Operational Framework were in place throughout the year and the Board, having reviewed their effectiveness, believes they accord with the Financial Reporting Council's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

Viability statement

As required by the provisions of the Code, the Board has undertaken an assessment of the future prospects of the Company taking into account the Company's current position and principal risks. This assessment was informed by the following business processes:

Risk management process

The Company has developed a structured approach to the management of risk (see above) and the principal risks identified are considered as part of the Board's annual review of the Integrated Business Plan.

Integrated Business Plan (IBP)

The IBP represents a common process with standard outputs and requirements that produces an integrated strategic and business plan for the Group and also for each of its businesses over the following five years. The use of a five-year period provides a robust planning tool against which long-term decisions can be made concerning, amongst other things, strategic priorities, funding requirements (including commitments to Group pension schemes), returns made to shareholders, capital expenditure and resource planning. Longer-term strategic inputs also form part of the IBP process and, where activity is required to meet such long-term priorities, this is provided for in the plan.

The detailed plan is reviewed each year by the Board as part of its strategy review process. Once approved by the Board, the IBP provides the basis for setting all detailed financial budgets and strategic actions across the businesses, and is subsequently used by the Board to monitor performance.

Liquidity analysis

The Board regularly reviews an analysis based on the financial output from the IBP, looking at the forecast working capital requirements, cash flow, and committed borrowing and other funding facilities available to the Company over the five-year period covered by the IBP. This analysis includes 'stress testing' of the Company's liquidity under severe, but plausible, scenarios as developed from the IBP, including the impact of changes to the terms of trade it enjoys with different customers and its funding commitments to Group pension schemes.

In undertaking its review of the IBP in 2016, the Board considered the prospects of the Company over the five-year period covered by the process. On the basis of this and other matters considered and reviewed by the Board during the year, the Board has reasonable expectations that the Company will be able to continue in operation and meet its liabilities as they fall due over the following five years. It is recognised that such future assessments are subject to a level of uncertainty that increases with time and, therefore, future outcomes cannot be guaranteed or predicted with certainty. Also, this assessment was made recognising the principal risks that could have an impact on the future performance of the Company (see pages 60 to 63).

Going concern statement

Accounting standards require that directors satisfy themselves that it is reasonable for them to conclude whether it is appropriate to prepare financial statements on a going concern basis and the Code requires that, if appropriate, this report includes a statement to that effect. Following review, the directors have concluded that it is appropriate to adopt the going concern basis for these financial statements and have not identified any material uncertainties concerning the Company's ability to do so in the 12-month period from the date of approving them. For this reason, they continue to adopt the going concern basis in preparing the accounts.

Directors

In compliance with the Code, all directors are subject to annual election by shareholders. The Chairman has confirmed that, based on the formal performance evaluations undertaken in 2016 and 2017, all remain committed to the role and the individual performance of all directors continues to be effective. Also, in compliance with the Code, the Company ensures that non-executive directors have sufficient time to fulfil their obligations. This is assessed when a director is appointed and also in the event of there being a material change to an individual's circumstances.

During the year, Ian Tyler was appointed chairman of AWE Management Limited, a non-listed company, which was in addition to his chairmanship appointments with Cairn Energy and Bovis Homes Group. In 2016, the Chairman led an assessment of Mr Tyler's other time commitments and agreed that they would not impact his ability to fulfil his commitments to the Company, but it was agreed that this should be reviewed on an annual basis. This review was undertaken and it was confirmed that his other commitments were not having an impact on his ability to fulfil his commitments to the Company. His other commitments have reduced recently as a result of him stepping down from the board of Mediclinic International plc.

Elizabeth Corley and Charles Woodburn, who joined the Board during the year, completed structured induction programmes.

The Company considers that all of the non-executive directors identified on page 69 of this report are independent in accordance with Code provisions.

Audit Committee report

Nick Rose
Chairman of the Audit Committee

Members

Nick Rose (Chairman)

Paula Rosput Reynolds

Ian Tyler

Dear Shareholders,

The section on the Audit Committee's year on page 75 provides an overview of the work that we have undertaken in the last 12 months and I would like to focus here on specific aspects.

The work performed by the Company's auditor is of fundamental importance to the Audit Committee and the wider Board, to management and, of course, to you as shareholders to whom the Independent Auditor's report on pages 117 to 120 is specifically addressed.

As planned, the Audit Committee has embarked on a process that will result in new auditors being appointed in 2018. One major aspect of re-tendering any external audit appointment is dealing with the potential loss of experience and expertise of the incumbent auditor and the inevitable learning curve faced by the incoming auditor. Continuity and consistency of audit quality is important and, as a Committee, we have been mindful of the need to allow for a shadow audit period encompassing both the 2017 half-year and full-year audits as part of the auditor appointment process. Audit rotation regulations going forward will require large companies to re-tender their external audit service no less frequently than every ten years.

The timeline for our audit re-tender process is shown below. As previously reported, KPMG LLP and their predecessors have been in place as the Company's auditors since 1981 without re-tender and, given the length of their current incumbency, have not been invited to tender, but are committed to ensuring a smooth transition. Our KPMG audit engagement partner, Ian Starkey, has been in this role since 2013 and the end of his five-year tenure, when he would otherwise rotate off our audit, will coincide with the appointment of a new audit firm.

The tender is being competed by highly capable and experienced international audit firms with strong track records and technical expertise. In coming to the shortlist, we concluded that the complexity of the Group and the scale of its international business require an incoming auditor to have the global reach and experience of one of the larger firms. Whilst there are no contractual obligations that would restrict the selection of an incoming auditor, increased regulatory restrictions on non-audit services work that can be undertaken by an incumbent auditor mean that both outgoing and incoming auditors have to be unencumbered by the provision to the audited entity of certain types of non-audit services and this, too, has been taken into account in the selection procedure.

The Committee agreed the Request for Proposal documentation sent to the selected firms and the Committee members have each met with the lead partners of the tendering firms. The process is on track and the Committee intends to be in a position to make our recommendation to the Board on a new auditor in May 2017 for the 2018 audit. The recommendation will then be put before shareholders at the 2018 Annual General Meeting (AGM).

External audit tender timeline

Prior to May 2016
Pre-audit qualification and independence enquiries

June 2016
Request for Proposal documents for selected firms agreed

Summer 2016
Meetings with lead partners of tendering firms

December 2016
Tender progress assessment

September 2016 to March 2017
Fact-finding process for tendering firms

External audit

Both the Committee and management – and indeed our current auditors – have been conscious of the importance of not letting the audit re-tender distract us from business-as-usual in the audit environment. Our discussions with KPMG have focused on audit scope and maintaining audit quality, as well as ensuring that we have an experienced, quality team in place following some recent rotations off our account.

In line with our usual practice, we have undertaken a review of the effectiveness of the external audit and the output of the review following the 2016 year-end audit enabled us to recommend to the Board that it seek shareholder approval for the re-appointment of KPMG LLP at the 2017 AGM. For the remaining year of KPMG's audit tenure – the financial year ending 31 December 2017 – the focus will be on a smooth transition to the new incumbent without compromising audit quality.

How the effectiveness of the external audit process was assessed

Who we survey:

- Executive directors
- Operating group/sector and line of business management
- Internal Audit Director
- Other senior executives, including key finance roles

Areas we cover:

- Understanding of the Group's risks
- Audit plan
- Robustness of audit processes
- Objectivity
- Quality of communications
- Ability to provide a seamless service across differing jurisdictions

Audit independence

As mentioned above, audit independence is coming under increasing focus and we have reviewed in detail the confirmation and information received from KPMG on the arrangements that they have in place to safeguard auditor independence and objectivity, including specific safeguards in place where they are providing permissible non-audit services to the Group.

Non-audit services policy

The Committee has a formal policy governing the engagement of the auditors to provide non-audit services which we review on an annual basis. The policy prohibits certain activities from being undertaken by the auditors and also places restrictions on the employment of former employees of the auditors.

Recognising that the auditors are best placed to undertake certain work of a non-audit nature, the policy permits the provision of Audit-Related Services and Permitted Non-Audit Services up to limits that are pre-approved by the Committee, with specific approvals required beyond such limits by the Committee.

As part of the 2016 review, we made revisions to the policy in order to ensure compliance with the Financial Reporting Council's revised regulations on ethical standards for auditors and EU regulations adopted by the UK which apply prohibitions to a range of engagements that could result in an auditor facing a conflict of interest. As a result, certain services formerly provided by KPMG, primarily tax services and investor information services, are no longer being provided by them with effect from 1 January 2017. A copy of the revised policy is available on the Company's website, baesystems.com.

Details of fees payable to the auditors are set out on page 132. In 2016, non-audit fees represented 19% of the audit fee. The principal non-audit services provided by the auditors related to tax compliance services, the interim review and investor information services.

Financial statements

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2016 financial statements were:

Recognition of revenue, profit and provisioning

We reviewed key estimates and judgements prior to publication of the financial statements. Our review included the key estimates and assumptions applied in determining the financial status of the more significant programmes, including Typhoon, UK aircraft carrier programme, Astute Class submarine programme, Saudi British Defence Co-operation Programme, losses on US commercial shipbuilding contracts, customer payments on export orders and JP 2008 Phase 3F programme for enhanced satellite communications services to the Australian Defence Force.

Pensions

Recognising the scale of the Group's pension obligation, we reviewed the key assumptions supporting the valuation of the retirement benefit obligation. This included a comparison of the discount and inflation rates used against externally-derived data. We reviewed the methodology used to allocate a proportion of the retirement benefit obligation to equity accounted investments and concluded that this was appropriate with reference to agreements between the Company and those companies. We also considered the adequacy of disclosures in respect of the sensitivity of the deficit to changes in these key assumptions (see page 163).

Goodwill

We considered the level of goodwill held on the Group's balance sheet in respect of a number of past major transactions and whether, given the future prospects of these businesses, the value of goodwill held on the balance sheet remains appropriate. The methodology for impairment testing used by the Group is set out in note 8 to the Group accounts on page 139. No goodwill impairments were identified as a result of this review.

May 2017
Selection of new auditors for recommendation to the Board

June 2017 to July 2017
Half-year results shadow period

August 2017
Announcement of half-year results

December 2017 to February 2018
Full-year results shadow period

February 2018
Announcement of full-year results

May 2018
Board recommendation at Annual General Meeting to appoint new auditors

Audit Committee report continued

Taxation

Whilst tax policy is ultimately a matter for the Board's determination, we reviewed the Group's tax strategy as set out on page 30. Twice during the year, we reviewed the Group's tax charge, tax provisions and the basis of recoverability of the deferred tax asset relating to the Group's pension deficit.

During the year, the Financial Reporting Council (FRC) reviewed the tax disclosures in the Company's 2015 Annual Report as part of the FRC's thematic review of tax reporting announced in December 2015. The tax disclosures of 32 other FTSE 350 companies were also reviewed. There were no major financial reporting changes arising from this review and the enquiries are closed[1].

Alternative Performance Measures

We reviewed disclosures to ensure that guidance issued by the European Securities and Markets Authority and the FRC was taken into account in the Annual Report.

Going concern and viability statements

The Committee agreed the parameters of, and reviewed the supporting report for, the going concern statement (see page 71) and the statement on the Board's assessment of the prospects of the Company (the viability statement on page 71) on the five-year period used in the Integrated Business Plan.

How we ensure that the Group's financial statements, taken as a whole, are fair, balanced and understandable

The process is:

- comprehensive guidance issued to all the contributors at operational level;
- a verification process dealing with the factual content of the reports;
- comprehensive reviews undertaken at different levels in the Group that aim to ensure consistency and overall balance; and
- comprehensive review by the directors and the Executive Committee.

Internal control and risk

The Board has delegated to the Committee responsibility for reviewing in detail the effectiveness of the Company's risk management and internal control system. The Committee's review of the effectiveness of internal controls has encompassed a review of the reports relating to the six-monthly Operational Assurance Statements (OAS), which are submitted by each business or function as a mandated policy under the Group-wide Operational Framework, and controls reports and reports from both internal and external auditors.

A key focus for the Committee is the controls environment surrounding the Company's Lifecycle Management (LCM) process, the bedrock of our programme execution and management. LCM is integral to the successful execution of the Group's projects and programmes, and of particular importance in the early identification of programme risk and the determination of profit recognition or provisioning which, you will see from above, tend to be areas where we are required to exercise judgement. We have discussed the outputs of general financial and LCM controls testing, and any required improvement actions, with management, and internal and external audit, with a view to ensuring the ongoing robustness of programme execution and risk mitigation.

We have reviewed the ongoing effectiveness of the Company's risk management processes as part of our wider review of internal controls. The Group's principal risks are set out on pages 60 to 63.

Internal audit

Internal Audit plays an integral role in the Company's governance structure and provides regular reports to the Committee, including the outputs of the twice-yearly OAS process and the tracking of remedial action in the case of any control failures.

The annual Internal Audit programme is agreed jointly by the Audit and Corporate Responsibility committees to ensure that the overarching programme covers not only financial risk, but also the assessment of the effectiveness of key areas of ethical and reputational risk. The assurance programme covers a broad range of audits covering areas such as mandated governance, OAS outputs, risk register findings, change programmes, and areas relating to responsible behaviour and non-financial risk, as well as accommodating ad hoc Internal Audit requests.

During the year under review, and separate from the normal regular sessions we hold with the Internal Audit Director without management present, we held a separate session with him which, together with output from the annual evaluation of the function, is helping us to shape the Internal Audit programme to leverage the use of this vital resource for valued-added assurance.

After discussion of the 2016 evaluation output with the Internal Audit Director, the Committee concluded that the Internal Audit function remains effective. We currently intend to undertake an external assessment of the function in 2017.

How the Committee assesses the effectiveness of Internal Audit

Who we survey:

- Group-wide heads of Audit Review Boards
- Other business leaders
- External auditors

Areas for requested feedback include:

- Role of Internal Audit and independence
- Audit planning, processes and execution
- People resources and skilling
- Reporting

Nick Rose
Chairman of the Audit Committee

1. In choosing to refer to the FRC's review, the Company is asked by the FRC to make clear that the FRC's role is not to verify the accuracy of the Company's report and accounts or other information provided to the FRC, but to consider compliance with reporting requirements. The FRC accepts no liability for reliance on its letters on this matter by any third party, including but not limited to, investors and shareholders.

Competition and Markets Authority Audit Order

The Committee has complied with the provisions of the Competition and Markets Authority Audit Order in respect of committee responsibilities and audit re-tending disclosures.

The Audit Committee's year

February

Committee

London, UK

- Considered the accounting, financial control and audit issues reported by the auditors that flowed from the audit work.
- Reviewed the financial statements and specific disclosures, including viability and going concern, for recommendation to the Board.
- Reviewed the effectiveness of the external audit process.
- Received a report from the Group Taxation Director.
- Considered output from the six-monthly OAS review.
- Reviewed the procedures and outputs for the identification, assessment and reporting of risk.
- Reviewed the effectiveness of the Company's helpline procedures in respect of the reporting of accounting or financial improprieties.
- Regular quarterly items[1].

Joint session with the Corporate Responsibility Committee:

- Agreed final iteration of the annual Internal Audit programme.

May

Committee

London, UK

- Agreed the AGM Trading Statement.
- Reviewed the fees for non-audit services.

June

Committee

Washington DC, US

- Agreed audit engagement and audit fee.
- Agreed audit strategy and scope.
- Reviewed external auditor independence issues.
- Agreed Request for Proposal, timeline and process for the audit re-tender.
- Discussed with external auditors the Financial Reporting Council's latest Quality Review on KPMG (which did not include the BAE Systems audit).
- Received a report on the Group's insurance arrangements.
- Considered output of the Internal Audit Director's report.
- Received a presentation from VP, Audit for the US businesses.
- Regular quarterly items[1].

Summer

Meetings

London, UK

- Meetings between individual Audit Committee members and lead partners of audit tender firms to discuss the audit re-tender.

July

Committee

London, UK

- Considered the accounting, financial control and audit issues reported by the auditors that flowed from the audit work.
- Reviewed the financial statements and specific disclosures, including going concern, for recommendation to the Board.
- Received a report from the Group Taxation Director.
- Considered output from the six-monthly OAS review.
- Reviewed the procedures and outputs for the identification, assessment and reporting of risk.
- Regular quarterly items[1].

Meeting

London, UK

- Informal meeting with the Internal Audit Director to discuss best practice developments in internal audit and its strategic development.

December

Committee

London, UK

- Assessed progress on the audit re-tender.
- Considered the external auditor's controls report.
- Considered output of the Internal Audit Director's report.
- Presentation from the Head of Internal Audit, Programmes & Support.
- Received a report on export control compliance.
- Amended the Non-Audit Services Policy.
- Discussed the first iteration of the annual Internal Audit programme.
- Set the parameters for work supporting the viability and going concern statements.
- Undertook a review of the effectiveness of the Internal Audit function.
- Regular quarterly items[1].

Committee composition and evaluation

The breadth of experience of the Audit Committee members is set out on page 69. The performance evaluation of the Committee is undertaken as part of the wider Board evaluation and the Board believes the Committee to have the appropriate composition and complement of skills to discharge its responsibilities.

Audit Committee timeline

February	May	June	July	December
Committee	Committee	Committee Meetings	Committee Meeting	Committee

1. The Committee reviews the nature and level of non-audit services (including independence safeguards from the incumbent auditor where it provides such services), and holds a separate session with the Internal Audit Director and external auditors without management present. The Audit Committee Chairman also meets separately with internal and external audit.

Corporate Responsibility Committee report

Ian Tyler
Chairman of the Corporate Responsibility Committee

Members

Ian Tyler (Chairman)

Harriet Green

Chris Grigg

Dear Shareholders,

On behalf of the Board, I am pleased to present the Corporate Responsibility Committee report. The aim of the report is to provide you with a view of the key activities undertaken by the Committee during the year, our areas of focus and what we plan to do in 2017.

At the beginning of 2016, the Committee agreed a business plan which set out our main areas of focus. This allowed us to schedule sufficient time to carry out deep-dive reviews in these areas. An important factor in the success of these reviews is ensuring that we meet with the right people from within the Company and hear directly from them about what we are doing. From them we can understand more about the practical implications of implementing our policies. This is particularly important as we operate across a number of countries and cultures and this can have an impact on the roll-out and embedding of Company-wide policies.

This year we have carried out detailed reviews on the following: safety; ethical behaviour; product safety; and diversity and inclusion. I will discuss each of these topics through this report.

Safety
Safety is one of our principal areas of focus and will remain so even though we are making steps towards achieving world-class performance in some of our businesses. The Committee has worked with management to develop an understanding of what world-class safety performance looks like and has agreed an approach to how all our businesses can challenge themselves to improve in this area. This includes the targets that are set for achievement at a Group level and the timeframe over which these are to be achieved. It is important that targets are realistic, but also drive continual improvement in the most effective way. The Committee is particularly interested in how best practice is shared, how change is implemented and embedded, and how we record information on safety and learn from it.

In 2015, we saw a reduction in the overall incident rate but, unfortunately, there was also an increase in major injuries. The Committee, therefore, reviewed the major individual injury incidents in depth to understand whether there were lessons learned that could be shared across the Company. In support of the safety agenda, the Committee also looked at how the performance objectives could be used to drive actions and behaviours to support a reduction in the significant risks at our sites – this being key to achieving long-term sustainable improvement.

Safety is one of the performance measures within the Annual Incentive Plan, which applies to the executive directors and also to all senior executives across the Company. At the end of 2016, the Committee reviewed safety performance at Group level and that of our principal businesses, and recommended the level of achievement to be recognised in the incentive plan.

In September, the Committee carried out a deep dive into the safety culture in our businesses in Saudi Arabia and Australia. We are an international business and we operate in many different countries, each of which has individual challenges when it comes to embedding our safety culture. In Saudi Arabia and Australia, we operate sites across a broad geographical area. This can present a challenge for the local management team to communicate effectively a consistent message on safety and to ensure that we are sharing best practice. Despite these challenges, the Committee was pleased to hear about the progress that was being made.

Ethical behaviour
This year, the Committee carried out a review of the processes in place to help ensure that the Company only takes on business that is consistent with its standards of integrity. This is governed by our Product Trading Policy – a principles-based approach to evaluating business opportunities requiring any responsible trading risks to be identified as part of a structured decision-making process. The Committee carried out a deep dive into the way in which our Applied Intelligence business has augmented its business-winning processes to incorporate the requirements of this policy and how it has tailored the process to its particular business model. In particular, we considered the escalation steps that would be used if a decision needed to be referred upwards, ultimately to the Board.

The Committee also reviewed the governance procedures for our overseas markets. The Company has a network of regional business development offices that act as the first port of call for any business unit seeking to do business in that region or country, and it is important that we have a consistent and robust approach to how we do business in all parts of the world. The Committee spent time discussing the management of overseas offices with our head of business development and chief legal counsel who support this function.

Product safety
Each year, the Committee reviews the Product Safety Policy. The integrity of our supply chain is crucial to our ability to provide high-quality products and services to our customers. We must, therefore, seek assurance at each stage of a product's lifecycle to ensure that our quality and ethical standards are being met.

Diversity and inclusion

Last year, I reported that we were reviewing how the Company planned to create a more diverse and inclusive workforce. The nurturing of our talent pipeline continues to be a key driver towards the long-term goal of bringing greater diversity into our senior management and executive teams. This is a long-term process which starts with the choices made by school-leavers and, therefore, general changes in the industry as a whole will take time to filter organically into the Company demographic. The Company is looking at what action it can take to support and drive the pace of this change. As a Committee, we considered the overall objective at Group level and what action can be taken to support this. During 2017, we plan to spend more time looking at the way this is approached at business unit level.

The agenda for the upcoming year will be developed to support the Committee in its understanding of the corporate responsibility challenges facing the business.

As you can see opposite, in 2016, we visited two of our UK military aircraft sites. Such visits are a great way for members of the Board to get out of the boardroom and engage directly with employees. We will be doing more of this in 2017.

Ian Tyler
Chairman of the Corporate Responsibility Committee

Corporate responsibility in action
Developing first-hand understanding of corporate responsibility

Site visit to Samlesbury and Warton

More online
baesystems.com

In 2016, the Committee took the opportunity to visit two of the key UK manufacturing sites, Warton and Samlesbury, Lancashire. Each year, we schedule a full-day visit as it gives an opportunity for the Committee to develop a first-hand understanding of the corporate responsibility successes and challenges across the business. This continues to be a valuable addition to the calendar as it allows us to meet with management and employees from different areas of the business. The focus of this visit was on corporate culture and how the diversity and inclusion agenda is being progressed by the Military Air & Information business. We visited the newly-opened Academy for Skills & Knowledge at Samlesbury and discussed with the management team the recruitment approaches and training paths for apprentices. During the year, the Committee has also reviewed the Product Safety Policy and the visit afforded us the opportunity to discuss how this is implemented practically and the questions that need to be asked when making product safety decisions.

The Corporate Responsibility Committee's year

February

Committee

London, UK

- Commercial and Procurement policy update.
- Review of performance against the safety objectives for 2015.
- Overview of current and emerging issues for the Corporate Responsibility Committee during 2016.

June

Committee

Washington DC, US

- Review of overseas governance processes.
- Review of Product Trading Policy.
- Diversity and inclusion update.

September

Committee

Baltimore, Maryland, US

- Product trading review, focusing on Applied Intelligence.
- Diversity and inclusion update.
- Safety review, focusing on the International operating group.

December

Committee

London, UK

- Review of annual lobbying report.
- Anti-bribery and corruption review.
- Culture and engagement review.
- Review of 2017 corporate responsibility audit review programme.
- Set safety objectives for 2017.

Corporate Responsibility Committee timeline

February
Committee

June
Committee

September
Committee

December
Committee

Nominations Committee report

Sir Roger Carr
Chairman of the Nominations Committee

Members

- Sir Roger Carr (Chairman)
- Elizabeth Corley
- Harriet Green
- Chris Grigg
- Paula Rosput Reynolds
- Nick Rose
- Ian Tyler

Dear Shareholders,

During the past 24 months, the Committee completed a thorough examination of both Board composition and senior management succession needs. This review was to ensure compliance with the highest governance standards and to identify and secure the mix and skills of the team that was appropriate to both current and future requirements.

In reviewing the senior Board membership it was acknowledged that the Chief Executive, Ian King, may wish to retire in 2017 after serving eight years in the role, but that all other executive Board positions were unlikely to change for the foreseeable future.

A thorough appraisal was conducted of candidates that were considered to have the mix of talent, experience, skills and forward career longevity suitable to take the Chief Executive role. In the light of this research, Charles Woodburn was recruited as Chief Operating Officer with a view that, after a period of industry assimilation and management responsibility, he would prove to be an appropriate successor.

I am pleased to report that, following the Committee's nomination, the Board has agreed to appoint Charles to succeed Ian King as Chief Executive when he retires on 30 June 2017.

In considering the non-executive roles on the Board, it was established that following the successful recruitment of Elizabeth Corley, the Board structure met the requirements of the UK Corporate Governance Code, having 11 members, of which one was an independent chairman, four executive and six non-executives (60% independent for the purposes of the Code) made up of three females (27%) and two of non-British origin (18%).

The skill set of the Board was identified as having large-scale industrial and commercial international management experience covering the areas of finance, engineering and government relationships.

The relatively small size of the Board is considered to work well, but on occasion places committee membership under pressure. Against this background and in the light of the skill set analysis, it is our intention to make a further two non-executive appointments over the next 18 months. Our ambition is to identify and appoint one male and one female non-executive, ideally with international contracting and/or cyber technology experience. These appointments will both strengthen the existing Board membership and prepare for the inevitable departure of Board members when they complete their third term in 2019.

In addition to Board membership, the Nominations Committee has continued to consider the development of the senior executive team. To ensure Board members have adequate exposure to succession plans, the formal Board site visits are supplemented by more intimate breakfasts and dinners to facilitate greater contact between Nominations Committee members and high-potential executive management. In 2016, these events proved to be both popular and valuable for directors and managers.

On a more formal basis, we continue to invite members of the Executive Committee to occupy a boardroom empty seat in order that they may gain useful exposure to the workings of a board.

Finally, in keeping with the Hampton Alexander report, it is our plan to improve further our gender balance in senior executive roles, strengthen the wider diversity of our talent pipeline and target 33% of Board positions to be held by women by 2020. By adopting this holistic approach of understanding and building the talent within the Company, whilst occasionally benchmarking and recruiting from outside the organisation, the Board and Nominations Committee consider they are discharging their responsibilities enthusiastically, professionally and appropriately.

Sir Roger Carr
Chairman of the Nominations Committee

Nominations Committee timeline

May	June	December
Committee	Committee	Committee

In addition to the formal Committee meetings, the Chairman met informally with non-executive directors on a number of occasions during the year to discuss Nominations Committee-related matters.

Remuneration Committee report

Paula Rosput Reynolds
Chairman of the Remuneration Committee

Members

Paula Rosput Reynolds (Chairman)
Elizabeth Corley
Nick Rose

Dear Shareholders,

Over the last year, there has been an elevated interest by shareholders and the UK government regarding executive remuneration. Concerns have been raised about the effectiveness of the incentives embedded in remuneration schemes, the alignment of remuneration with shareholder interests and business outcomes, and the quantum of rewards afforded to top-level executives. While listed companies have often sought to standardise their plans, there is a growing recognition that one size does not fit all.

It is with this backdrop in mind that the Remuneration Committee (the Committee) has considered both the administration of our current reward framework and the refreshment of our remuneration policy (the Policy), the latter of which will be subject to a shareholder resolution at the 2017 Annual General Meeting (AGM). We believe that we've made substantial progress in recent years to build a more direct alignment between the Company's strategy and the creation of shareholder value. At this same time, we have sought to reduce the complexity of our long-term incentive arrangements. But this effort is always a work in progress; as business circumstances change, so must we adapt our policies.

2017 is, in many ways, a crossroads year for BAE Systems. We remain subject to rapidly-changing political, economic, defence and security conditions around the world. Such circumstances require that we redouble our efforts to be responsive to the environment and to innovate for the long-run health of our business. As already announced, Ian King will retire and Charles Woodburn has been appointed as Chief Executive effective 1 July 2017. Additionally, given the demographics of our workforce, we anticipate that there will be a number of other senior-level retirements and individuals appointed to replace them over the next three to five years. Under the guidance of our Chairman, Sir Roger Carr, the Board has undertaken a programme which will not only assure a smooth transition of leadership but also inspire our employees to embrace change.

Thus, given the external environment of heightened sensitivity on remuneration, potential senior leadership changes and the exigencies of our business, the Committee has had much to consider over the last number of months. This letter elaborates on the Committee's thinking and reflects the extensive input we have received from major shareholders. We provide substantial detail in this letter so that all shareholders can equally consider the various concerns and trade-offs that the Committee has considered in proposing changes to the policy.

Nevertheless, the Committee's overarching goal remains the same – to ensure that we are providing the proper incentives for sustainable high performance by our executive team, to do so with transparency for our stakeholders, and to assure alignment between business results and rewards conferred.

Context to the Committee's decisions

The Committee is concerned with the full spectrum of executive employment matters: recruiting, promoting and retaining the best top-level leaders, setting the incentives under which these leaders operate, and monitoring the results they produce and the manner in which they produce them. Our overall remuneration framework has a number of specific objectives. It is designed to motivate our key talent to achieve the Company's strategic objectives, to deliver on customer commitments, to lead and inspire employees, and to drive value for our shareholders. It is also designed to be competitive in the various markets in which we operate and compete for talent.

There are multiple considerations in the design of the overall framework. First, is the balance of short-term and long-term incentives. Second, is the interplay between Group and business segment results and individual accomplishments, as well as the level of reward afforded to employees in the wider Group. Third, is to distinguish between the precise numerical results and the character of the results themselves, including the manner in which they are achieved. Fourth, is the balance between absolute shareholder value creation and the Group's performance relative to peers.

Our short-term programme metrics are tied to Group performance, business segment performance and individual goals, including the leadership behaviours that underpin BAE Systems' Total Performance culture. Our long-term incentive programme measures absolute performance of the Group and performance relative to peers. Our framework is intended to foster accountability for sustaining and growing the Group in a responsible manner.

In addition to developing the overall remuneration policy and framework, the Committee assesses the level of challenge within our Annual and Long-Term Incentive Plan targets. Annually, in November, the full Board reviews and adopts the Integrated Business Plan. Thereafter, the Committee reviews the specific business targets/metrics for the one and three-year periods and examines the underlying assumptions, including the degree of 'stretch' contained within them. After setting one and three-year targets, the Committee periodically reviews progress towards the attainment of the objectives. After the close of each year, the Committee undertakes a thorough review of annual and three-year performance. Separately, the Committee regularly considers the overall construct of the remuneration package to ensure that potential pay outcomes are appropriate and reasonable against different performance scenarios.

Remuneration Committee report
continued

Summary of key decisions for 2016

- Determination of remuneration package applicable to newly-appointed Chief Operating Officer in May 2016.
- Salaries of the Chief Executive and Chief Operating Officer are not being increased for 2017.
- Salary of the Group Finance Director is being increased by 2.5% from 1 January 2017.
- Salary of the President and Chief Executive Officer of BAE Systems, Inc. is being increased by 3.0% from 1 January 2017.
- Fee for the Chairman is being increased from £650,000 to £700,000 from 1 February 2017 and is fixed for three years.
- Awards granted in spring 2016 of Performance Shares, Share Options and (to US executive director only) Restricted Shares.
- Application of a performance range of 3% to 7% average annual Earnings per Share (EPS) growth with 25% vesting at threshold to Long-Term Incentive (LTI) awards and 50% of the Total Shareholder Return (TSR) measure based on the current peer comparator group and 50% based on a TSR percentile ranking against the companies in the FTSE 100 index.
- Appointment of new independent adviser Willis Towers Watson.

Rationale for the 2017 remuneration policy requiring approval at 2017 AGM

Earlier this year, the Committee conducted an extensive review of the effectiveness of our approved 2014 remuneration policy to determine whether it contained sufficient flexibility in our future arrangements. The Committee concluded that, overall, the current reward framework is broadly working and recognised that shareholders have consistently demonstrated a high level of support for the Committee's application of the policy. In terms of overall design principles, our review confirmed that the current design construct of base salary, Annual Incentive and LTIs remains appropriate. Importantly, we propose no changes to the overall quantum of LTI expected value for executive directors.

The Committee has spent considerable time examining the various alternative constructs being advocated by shareholders and government. Many of these constructs are already featured in our plans, such as the use of restricted shares in lieu of performance-based shares or options; longer mandatory holding periods for shares; and higher levels of minimum shareholdings by executives. The following revisions to our policy are proposed taking account of shareholder recommendations. In addition, recognising public interest in pay differentials, we are disclosing the pay ratio of our current Chief Executive to that of the average employee of the Group.

Maintain quantum

As a demonstration of the Committee's commitment to continued restraint, there will be no change to Annual Incentive opportunity levels or LTI expected value levels.

As shareholders will recognise, there is an important distinction between the face (or 'headline') award values and the expected value of the different LTI vehicles which takes into account the performance conditions on Performance Shares and Share Options, and the inherent share price growth requirement to deliver value as summarised in the following table:

	LTI headline award (% of salary)	**LTI expected value (% of salary)**
Chief Executive	550	**185**
Chief Operating Officer	530	**175**
Group Finance Director	515	**167.5**
President and Chief Executive Officer of BAE Systems, Inc.	732	**299**

We believe reliance on headline values in judging the appropriateness of remuneration plans is misplaced since it does not account for the challenging performance conditions and the share price appreciation needed to create realised value.

Adjust LTI metrics to align with strategic objectives

A key conclusion of the review found that, whilst the LTI structure is broadly working, better alignment is possible between LTI vesting outcomes and Group performance and shareholder experience. The Committee has previously recognised the need for better alignment and, in 2016, the Committee added a second TSR measure that benchmarks BAE Systems' performance, not just to its peer group, but to the broader group of FTSE 100 companies. This change was intended to align realisation of equity by executive directors with the value created for the UK shareholder base, whose preferences for income differ from the US shareholder base of BAE Systems' global defence peers.

Notwithstanding the improvement in alignment that we anticipate will be fostered by this FTSE component to the TSR, the Committee believes TSR may be a more volatile indicator when used by itself as a means for vesting shares. Prospectively, the Committee proposes to introduce EPS alongside TSR as a performance condition applicable to Share Options granted to the executive directors, with an equal 50% weighting on EPS and 50% on TSR (as currently applies to Performance Shares).

Business performance and incentive outcomes in 2016

		2016 performance	2016 incentive outcome
Group EPS	AIP	38.5p	● (Between target and stretch)
Group cash	AIP	£(1,386)m	● (Between target and stretch)
Group order intake	AIP	£20.9bn	● (Between target and stretch)
Average three-year EPS growth	LTI	<5%	● (Below threshold)
Three-year TSR	LTI	49.1%	● (Below threshold)
Recordable Accident Rate (per 100,000 employees)	AIP	580	● (Between target and stretch)
Major injuries recorded	AIP	39	● (Between target and stretch)

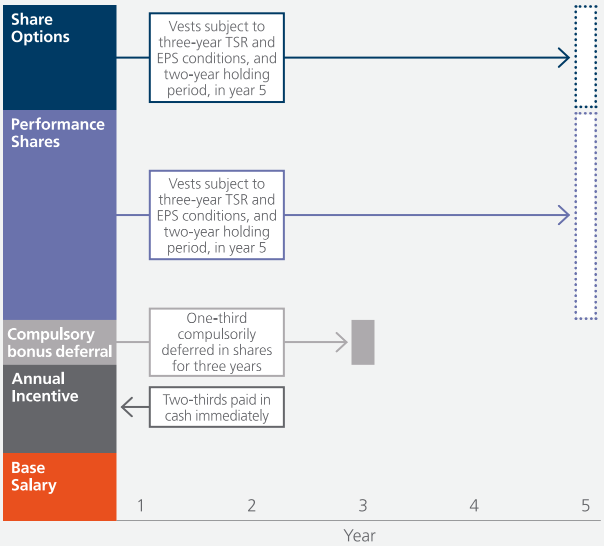
● Below threshold
● Between threshold and target
● Between target and stretch

AIP Annual Incentive Plan
LTI Long-Term Incentive

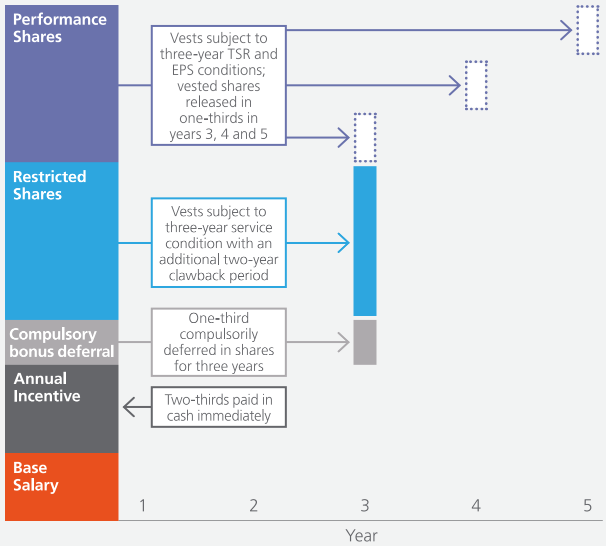
This resulted in the following incentive outcomes:

- 2016 annual bonus payouts for the executive directors ranged from 82.3% to 92.8% of maximum; and
- Performance Share Plan and Share Option awards granted to executive directors in March 2014 will lapse in 2017 as the performance conditions were not met.

Application of 2018 package for UK executive directors



Application of 2018 package for US executive director



Charts are illustrative and are not to scale. Details of executive director remuneration packages are on page 83. The full Policy for approval at the 2017 AGM is on pages 99 to 111.

Our rationale for this enhancement is to recognise the strategic importance of achieving consistent absolute growth in our markets, not just relative performance.

In summary, the Committee continues to support the use of TSR so that there remains an external benchmark of the Group's performance to both defence and FTSE peers. At the same time, the Committee believes that including three-year earnings targets keeps our executives focused on achieving absolute growth over each planning period.

Application of reasonable discretion

The Committee is mindful of the shareholder requirement for the Committee, and ultimately the Board, to exercise judgement when determining remuneration awards. In addition to the TSR and EPS primary performance tests, the Committee confirms and recognises its obligation to judge the overall reasonableness of the rewards received relative to the overall business actions and results achieved. When determining the final performance condition outcome under the LTIP, the Committee may exercise discretion over the number of Performance Shares and/or Share Options vesting in the light of other important factors in the business (reasonable discretion). Such factors may include specific financial and/or operating conditions as well as judgements regarding the overall health and sustainability of the Group. Whilst the exercise of such discretion may result in vesting of awards going upwards, the Committee fully appreciates the importance to shareholders of this being used in a balanced way, with clear demonstration of willingness to apply downward adjustments before seeking to increase the potential vesting outcome at a future point in time.

Modify the mix of LTI awards for the US executive director

Following an extensive review, which included data provided by an independent third-party adviser with expertise in the US defence sector, and in consultation with the board of BAE Systems, Inc., the Committee has identified that the current LTI construct and realisable pay opportunity for our US executive director is significantly out of line relative to US peer companies. Differences in typical US market practice, such as the award of share options not being subject to a further performance hurdle, mean that the actual reward received by our US executive director lags that of US peers by approximately 20%. This is an unsustainable position and may in time affect our ability to recruit and retain top-tier talent for this critical position.

To address this issue, and without increasing the overall expected value of the LTI, we are proposing to simplify the current construct of the US executive director's package by eliminating the use of Share Options and structuring the design of the LTI with an equal weighting in expected value in Performance Shares and Restricted Shares as follows:

	Expected value (% of salary)	
	Current	Proposed
Performance Shares	121	149
Share Options	78	–
Restricted Shares	100	150
Total	**299**	**299**

At the same time, we intend to increase the Minimum Shareholding Requirement applicable to the US executive director from 350% to 425% of salary, consistent with the higher grant of Restricted Shares and in keeping with US market practice.

The limits applicable to awards of Restricted Shares contained within the current policy will be revised accordingly, with the maximum limit on awards being raised from 100% to 150% and with no more than 50% of the overall LTI expected value being delivered in Restricted Shares.

Increase period from grant to final release

The Committee proposes to increase the period from grant to final release to five years in respect of Performance Shares and Share Options. This will be structured as a three-year performance period with a further two-year holding period on both Performance Shares and Share Options and is applicable to our UK executive directors.

Recognising that extending the vesting/holding period beyond three years would significantly reduce the competitiveness of the LTI offering in the US, the Committee intends to retain the current LTI vesting/release profiles for the US executive director as follows:

- Performance Shares: three-year performance period with phased release of one-third at the end of years 3, 4 and 5.
- Restricted Shares: three-year vesting period with an additional two-year clawback period.

Remuneration Committee report continued

Concluding comments
On behalf of my colleagues on the Committee, and indeed the entire Board, we appreciate the input we have received from shareholders and representatives of institutional investors. These conversations and comments have been influential in refreshing our policy. Striking the right balance between standardised plans and bespoke solutions is a challenging exercise.

The Committee believes that the recommended changes will ensure that our arrangements are reasonable relative to the complexity and challenge of the Group's business, are globally competitive, and remain aligned to the Company's strategic goals and to the interests of our shareholders.

On behalf of the Board

Paula Rospут Reynolds
Chairman of the Remuneration Committee

The Remuneration Committee's year

January
Committee

London, UK
- Considered offer package for incoming Chief Operating Officer.

February
Committee

London, UK
- Determined 2015 bonuses against performance for executive directors and Executive Committee members for payment in March 2016.
- Approved 2015 Group All-Employee Free Share Plans payments.
- Determined vesting outcome for 2013 Long-Term Incentive awards.
- Approved 2016 Long-Term Incentive awards and associated performance targets for executive directors and Executive Committee members.
- Agreed 2016 objectives for executive directors and Executive Committee members.
- Reviewed feedback from shareholder consultation on 2016 remuneration review.
- Reviewed Remuneration Committee terms of reference.
- Approved 2015 Annual remuneration report.

Spring
Re-tender

London, UK

Re-tender for Independent Adviser to Remuneration Committee.
- Selected new Independent Adviser.

May
Committee

Farnborough, Hampshire, UK
- Considered remuneration design and external market trends and themes for 2017 Directors' remuneration policy renewal.

September
Committee

Baltimore, Maryland, US
- Considered proposed changes to 2017 Directors' remuneration policy renewal.
- Agreed process for early shareholder consultation on Directors' remuneration policy.
- Agreed basis for 2017 annual remuneration review.
- Reviewed and set the Chairman's fee for a three-year period.
- Received update on progress against Annual Incentive Plan objectives for executive directors and Executive Committee members.
- Received update on performance conditions for Long-Term Incentive awards.

November
Committee

Farnborough, Hampshire, UK
- Reviewed feedback from early shareholder consultation on 2017 Directors' remuneration policy renewal.
- Reviewed level of executive directors' and Executive Committee members' shareholdings relative to the Minimum Shareholding Requirement.
- Reviewed dilution levels and share usage under Employee Share Plans.
- Approved operation of Group All-Employee Free Share Plans.

December
Committee

London, UK
- Reviewed and set salaries and bonus opportunity levels for executive directors and Executive Committee members.
- Proposed and set 2017 Annual Incentive targets.
- Considered further updates on early shareholder consultation on 2017 Directors' remuneration policy renewal.
- Reviewed draft 2016 Annual remuneration report.

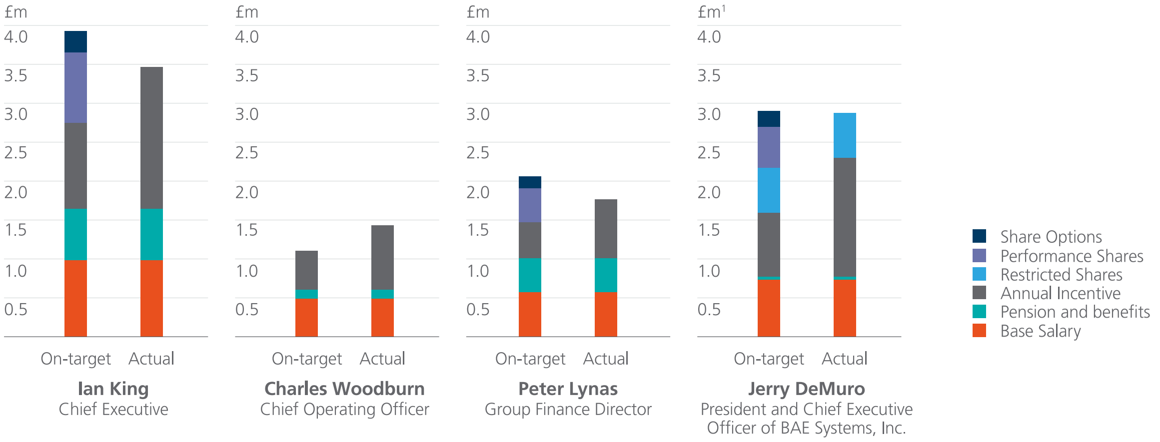
Remuneration Committee timeline

January	February	May	September	November	December
Committee	Committee	Committee Re-tender	Committee	Committee	Committee

Annual remuneration report at a glance

Executive directors' remuneration

The charts below show the 2016 actual remuneration achieved, as disclosed in the single total figure of remuneration on page 85, compared with the 2016 on-target opportunity. On-target remuneration assumes target vesting of incentives payable in respect of the performance period with year-end 2016. For Charles Woodburn, the figures below exclude the one-off cash payment of £1,620,000 to recognise forfeited compensation from his previous employer, which does not form part of usual annual remuneration.



1. The figures for Jerry DeMuro have been converted from US dollars to sterling.

Summary of remuneration framework

The overall remuneration framework applicable to each of the four executive directors under the current policy is summarised in the following table. The proposed changes to the policy[1] which will apply subject to shareholder approval at the 2017 Annual General Meeting are shown in italics.

	Purpose and link to strategy		Ian King CEO	Charles Woodburn[2] COO	Peter Lynas GFD	Jerry DeMuro CEO Inc.
Base Salary (with effect from 1 January 2017)	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.		£982,300	£750,000	£585,275	$1,023,000
Pension and benefits	Provide competitive benefits.		Defined benefit	Defined contribution	Defined benefit	Section 401(k) defined contribution
Annual Incentive	Drive and reward annual performance of individuals and teams on both financial and non-financial metrics, including leadership behaviours, in order to deliver sustainable growth in shareholder value. Compulsory deferral into shares increases alignment with shareholder interests.	Level (on-target/ maximum opportunity) (% salary)	112.5%/225%	100%/200%	80%/160%	112.5%/225%
		Performance condition	80% financial/20% non-financial			
		Deferral into Deferred Bonus Plan	One-third compulsory deferral			
Performance Shares	Drive and reward delivery of sustained long-term Earnings per Share (EPS) and Total Shareholder Return (TSR) performance aligned to the interests of shareholders.	Grant (% salary)	250%	230%	215%	242% *(298%)*
		Performance condition	50% on relative TSR/50% on three-year EPS growth			
Share Options	Drive and reward delivery of sustained long-term EPS and TSR performance and sustained improvement in the Company's share price.	Grant (% salary)	300%	300%	300%	390% *(Nil)*
		Performance condition	Relative TSR *(Equal split on EPS growth and relative TSR)*			
Restricted Shares	Provide long-term reward through time-vesting awards principally in the Company's US market.	Grant (% salary)	n/a			100% *(150%)*
Minimum Shareholding Requirement	Provide long-term alignment with shareholder interests.	(% salary)	300%	200%	200%	350% *(425%)*

1. The full Directors' remuneration policy for shareholder approval at the 2017 Annual General Meeting is set out on pages 99 to 111.
2. The appointment of Charles Woodburn as Chief Executive with effect from 1 July 2017 is described on page 91.

Annual remuneration report

for the year ended 31 December 2016

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2016 and will be proposed for an advisory vote by shareholders at the 2017 Annual General Meeting (AGM). It has been prepared on the basis prescribed in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

Directors' remuneration in the year ending 31 December 2017

For the purposes of the Companies Act 2006, the current Directors' remuneration policy (the Policy) at the date of this report took legal effect on 1 January 2015. The Policy has been operating in practice since the date of its approval on 7 May 2014 at the 2014 AGM. The remuneration for 2017 will be implemented as follows:

- The salaries of the current Chief Executive and Chief Operating Officer are not being increased for 2017 and remain at £982,300 and £750,000, respectively.
- The salary of the Group Finance Director is being increased by 2.5% to £585,275 with effect from 1 January 2017.
- The salary of the President and Chief Executive Officer of BAE Systems, Inc. is being increased by 3.0% to $1,023,000 with effect from 1 January 2017.
- Annual and Long-Term Incentive opportunity levels remain in line with 2014 approved Policy.
- The performance measures and weightings for 2017 for the Annual Incentive and Long-Term Incentives are set out on pages 101 and 103, respectively.
- The Committee is of the view that bonus targets for the Annual Incentive are commercially sensitive and that it would be detrimental to the Company to disclose them in advance. The targets will be disclosed retrospectively after the end of the relevant financial year.
- The fee for the Chairman has been reviewed and is being increased from 1 February 2017 to £700,000 per annum. This fee will not be reviewed for a three-year term.

On 22 February 2017, the Company announced that Ian King would be retiring as Chief Executive on 30 June 2017 (see page 91 for related arrangements) and that Charles Woodburn, Chief Operating Officer, would be appointed as Chief Executive with effect from 1 July 2017. On becoming Chief Executive, Charles Woodburn's base salary will increase to £875,000 per annum. All other provisions of his remuneration package will be as set out in the Company's current remuneration policy in respect of the Chief Executive role.

The following decisions have been taken by the Non-Executive Directors' Fees Committee (the composition of which is detailed on page 98):

- The fee structure for non-executive directors has been reviewed and is being increased for the first time since 2012 with effect from 1 April 2017 as follows:
  - Basic fee to be increased from £75,000 to £80,000 per annum.
  - Senior Independent Director's fee to be increased from £20,000 to £25,000 per annum.
  - Remuneration Committee Chairman's fee to be increased from £20,000 to £25,000 per annum.
  - Corporate Responsibility Committee Chairman's fee to be increased from £20,000 to £25,000 per annum.
  - Audit Committee Chairman's fee to remain unchanged at £25,000 per annum.
  - Travel allowance of £4,500 per meeting, payable on each occasion that a scheduled Board meeting necessitates air travel of more than five hours (one way), subject to a maximum of six travel allowances per year, to remain unchanged.
  - No further review of non-executive fees to be undertaken until 1 April 2020.

Contents

Remuneration policy

The Company's current remuneration policy approved at the 2014 AGM is available on the Company's website: baesystems.com

The Company's proposed remuneration policy for approval at the 2017 AGM is detailed on pages 99 to 111.

Single total figure of remuneration

Single total figure of remuneration for the Chairman and non-executive directors

	Fees		Benefits		Other		Total	
	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000
Chairman								
Sir Roger Carr	**650**	650	**–**	–	**–**	–	**650**	650
Non-executive directors								
E P L Corley[1]	**69**	n/a	**2**	n/a	**9**	n/a	**80**	n/a
H Green	**75**	75	**2**	8	**9**	4	**86**	87
C M Grigg	**75**	75	**–**	2	**9**	9	**84**	86
P Rosput Reynolds	**95**	85	**7**	7	**27**	23	**129**	115
N C Rose	**120**	120	**2**	2	**9**	4	**131**	126
C G Symon[2]	**n/a**	43	**n/a**	4	**n/a**	14	**n/a**	61
I P Tyler	**95**	95	**1**	2	**9**	9	**105**	106

1. Appointed to the Board on 1 February 2016.
2. Retired from the Board on 12 June 2015.

Chairman
Sir Roger Carr was appointed as Chairman on 1 February 2014 on a fixed annual fee of £650,000 throughout his initial three-year term as Chairman.

Non-executive directors
The fee structure for 2016 for the non-executive directors on a per annum basis was as follows: (i) Chairman, Audit Committee: £100,000; (ii) Chairman, Corporate Responsibility Committee: £95,000; (iii) Chairman, Remuneration Committee: £95,000; (iv) other non-executive directors: £75,000; and (v) additional fee for Senior Independent Director: £20,000. These amounts are shown in the 'Fees' column above. A travel allowance of £4,500 per meeting is also paid on each occasion that a non-executive director's travel necessitates air travel of more than five hours (one way) to the meeting location, subject to a maximum of six travel allowances per year. These amounts are shown in the 'Other' column. The amounts in the 'Benefits' column relate to travel expenses and subsistence; the amount for Chris Grigg in 2016 was £308.

The above table has been subject to audit.

Single total figure of remuneration for the executive directors

	Base salary		Taxable benefits[1]		Bonus[2]		LTIP[3]		Pension[4]		Other[5]		Total	
	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000	2016 £'000	2015 £'000
I G King	**982**	963	**47**	47	**1,820**	1,569	**–**	–	**613**	349	**1**	1	**3,463**	2,929
C N Woodburn*[6]	**486**	n/a	**17**	n/a	**823**	n/a	**n/a**	n/a	**95**	n/a	**1,621**	n/a	**3,042**	n/a
P J Lynas	**571**	557	**34**	39	**752**	659	**–**	–	**405**	396	**1**	–	**1,763**	1,651
J DeMuro[7]	**736**	637	**25**	23	**1,531**	1,223	**–**	–	**12**	10	**693**	657	**2,997**	2,550

* Appointed to the Board on 9 May 2016.

The above table has been subject to audit.

1. The benefits received by Ian King include the provision of a car allowance and the private use of a chauffeur-driven car (2016 £47k; 2015 £47k). The benefits received by Charles Woodburn include the provision of a car allowance and the private use of a chauffeur-driven car (2016 £17k; 2015 n/a). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2016 £19k; 2015 £17k). In addition, Peter Lynas received a second residence allowance of £15k (2015 £22k) on the basis disclosed in previous years. Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (2016 £4k; 2015 £4k); medical and dental benefits (2016 £12k; 2015 £11k); insured life and disability benefits (2016 £8k; 2015 £7k); and the private use of a company aircraft (2016 £1k; 2015 £1k).
2. Further detail on bonus payments is provided on page 87. One-third of the net bonus paid to Ian King, Charles Woodburn, Peter Lynas and Jerry DeMuro will be deferred compulsorily into BAE Systems shares for a three-year period, without additional performance conditions.
3. This column relates to the estimated or actual value of Long-Term Incentive Plans for which the performance period ended in the relevant financial year. The 2014 PSP^{EPS} award (for which the performance period ended on 31 December 2016) did not meet the Earnings per Share (EPS) performance condition and will lapse. The 2014 PSP^{TSR} and ExSOP^{2012} awards (for which the performance periods also ended on 31 December 2016) did not meet their TSR performance condition and will lapse.

Annual remuneration report
continued

4. The figures for Ian King and Peter Lynas in this column reflect defined benefit arrangements and have been calculated in line with the method set out in Section 229 of the Finance Act 2004 using a capitalisation factor of 20 to assess the increase in the value of the pension promise over the year, net of inflation. Therefore, these figures are sensitive to salary increases and Consumer Prices Index (CPI) inflation as follows:
   - Salary increase: Pensionable salary is averaged over three years. The differential between the 2016 and prior year figures for Ian King reflects his first salary increase in 2016 since 2012.
   - CPI inflation: In a year with high CPI inflation, the increase in the value of the pension promise would be lower than in a year with lower CPI inflation. For the 2016 figures, the reference CPI inflation has been floored at 0%.

   The figures for Charles Woodburn relate to a salary supplement in lieu of Company pension contributions.

   The figures for Jerry DeMuro include company contributions paid into his Section 401(k) defined contribution arrangement.
5. This column includes (i) the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) of £530 for Ian King, Peter Lynas and half this amount for Charles Woodburn, and Matching Shares under voluntary investment in the SIP for Ian King and Charles Woodburn; (ii) for Charles Woodburn, the cash payment of £1,620,000 to recognise forfeited compensation from his previous employer, as set out in note 6 below; and (iii) for Jerry DeMuro, the value of the 2016 grant of Restricted Shares. This award formed part of Jerry DeMuro's 2016 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached; his prior year figure relates to a similar Restricted Shares award in 2015.
6. As previously reported, Charles Woodburn was appointed as Chief Operating Officer on 9 May 2016 and joined the Board as an executive director on the same date. His salary on appointment was £750,000, with a maximum bonus opportunity of 200% of salary, of which one-third will be deferred in shares for a period of three years. He also receives LTIP awards at the following levels: Performance Share award of 230% of salary and Share Option award of 300% of salary as described on pages 102 and 103. In addition, he received the following awards to take into account the fair value of the awards being forfeited which significantly extend the vesting/holding period of the incentives being given up:
   (i) cash payment of £1,620,000 in respect of incentives earned and payable within six months, of which 50% of this net amount must be used to purchase BAE Systems shares within 120 days following payment. Due to BAE Systems being in a closed period from 1 January until the announcement of the Company's results on 23 February, the Remuneration Committee agreed to extend the period in which Charles is required to buy the shares to the end of February 2017. These shares must continue to be held in accordance with BAE Systems' Minimum Shareholding Requirement (which has been set at 200% in respect of his appointment); and

   (ii) a one-off grant of Performance Shares equal to 266% of salary, subject to the same performance conditions applicable to awards made under the LTIP as set out on page 92 with vesting in equal tranches of one-third in 2019, one-third in 2020 and the final third in 2021.

   His pension arrangements are set out on page 91.
7. Jerry DeMuro is paid in US dollars with the disclosed figures above being converted into sterling at the required exchange rate. The 2016 salary figure reflects his 2.5% salary increase and the exchange rate fluctuations experienced in 2016.

Note: On 22 February 2017, the Company announced that Ian King would be retiring as Chief Executive on 30 June 2017 and that Charles Woodburn, Chief Operating Officer, would be appointed as Chief Executive with effect from 1 July 2017. See page 91 for related details.

Annual bonus

Annual bonuses for the 2016 year are paid in March 2017. Annual bonus is made up of financial metrics, safety and personal objectives, designed to support the achievement of certain strategic outcomes necessary for sustaining the Group's long-term vitality. The breakdown of bonus measures, achievement and pay-out for each executive director is shown below. One-third of the net bonus payment is subject to compulsory deferral into BAE Systems shares for a three-year period, for which there is no additional performance condition.

Chief Executive

Measures		Weight (as a percentage of target)	Actual performance against targets set: Below	Threshold	Target	Stretch	Threshold for 2016	Target for 2016	Stretch for 2016	Actual performance[1]	Percentage of maximum opportunity
Financial	Group EPS	40.0					37.0p	38.0p	40.0p	38.5p	62.5%
	Group cash	25.0					£(2,602)m	£(2,336)m	£(1,805)m	£(1,386)m	100.0%
	Group order intake	15.0					n/a	£19.5bn	£20.2bn	£20.9bn	100.0%
Personal	Safety	5.0					See note 2 below				90.0%
	Key strategic objectives	15.0					See note 3 below				85.5%
										Total bonus (as a percentage of maximum)	**82.3%**

Chief Operating Officer

Measures		Weight (as a percentage of target)	Actual performance against targets set: Below	Threshold	Target	Stretch	Threshold for 2016	Target for 2016	Stretch for 2016	Actual performance[1]	Percentage of maximum opportunity
Financial	Group EPS	40.0					37.0p	38.0p	40.0p	38.5p	62.5%
	Group cash	25.0					£(2,602)m	£(2,336)m	£(1,805)m	£(1,386)m	100.0%
	Group order intake	15.0					n/a	£19.5bn	£20.2bn	£20.9bn	100.0%
Personal	Safety	5.0					See note 2 below				90.0%
	Key strategic objectives	15.0					See note 3 below				85.5%
										Total bonus (as a percentage of maximum)	**82.3%**

Group Finance Director

Measures		Weight (as a percentage of target)	Actual performance against targets set: Below	Threshold	Target	Stretch	Threshold for 2016	Target for 2016	Stretch for 2016	Actual performance[1]	Percentage of maximum opportunity
Financial	Group EPS	40.0					37.0p	38.0p	40.0p	38.5p	62.5%
	Group cash	25.0					£(2,602)m	£(2,336)m	£(1,805)m	£(1,386)m	100.0%
	Group order intake	15.0					n/a	£19.5bn	£20.2bn	£20.9bn	100.0%
Personal	Safety	5.0					See note 2 below				90.0%
	Key strategic objectives	15.0					See note 3 below				85.5%
										Total bonus (as a percentage of maximum)	**82.3%**

President and Chief Executive Officer of BAE Systems, Inc.

Measures		Weight (as a percentage of target)	Actual performance against targets set: Below	Threshold	Target	Stretch	Threshold for 2016	Target for 2016	Stretch for 2016	Actual performance[1]	Percentage of maximum opportunity
Financial	Group EPS	13.3					37.0p	38.0p	40.0p	38.5p	62.5%
	Group cash	8.3					£(2,602)m	£(2,336)m	£(1,805)m	£(1,386)m	100.0%
	Group order intake	5.0					n/a	£19.5bn	£20.2bn	£20.9bn	100.0%
	BAE Systems, Inc. profit	26.7					$1,051m	$1,070m	$1,124m	$1,130m	100.0%
	BAE Systems, Inc. cash	16.7					$1,706m	$1,777m	$1,918m	$2,100m	100.0%
	BAE Systems, Inc. order intake	10.0					n/a	$9.8bn	$10.2bn	$10.5bn	100.0%
Personal	Safety	5.0					See note 2 below				100.0%
	Key strategic objectives	15.0					See note 3 below				85.5%
										Total bonus (as a percentage of maximum)	**92.8%**

The above table has been subject to audit.

1. Adjusted to be on a like-for-like basis with the targets.
2. Performance against the safety element of the bonus was determined by the Corporate Responsibility Committee taking account of the level of significant risk reduction and improvement in safety culture, as well as targeted improvements against key safety indicators including an improvement in recordable accidents. The US business demonstrated stretch performance against each of these factors, resulting in a maximum award against this element of the bonus in the case of the President and Chief Executive Officer of BAE Systems, Inc.
3. Achievement of key strategic objectives is determined by the Remuneration Committee based on performance against a combination of base and premier objectives relating to the delivery of the Group's strategic objectives and demonstration of leadership behaviours. The assessment of the key strategic objectives for each director is as follows:
   - Chief Executive Ian King was, among other things, tasked with goals relating to growing the order book, facilitating major programme awards and preparing the organisation for leadership succession. With the exception of obtaining certain export awards within 2016, he substantially met the goals as agreed.
   - Chief Operating Officer Charles Woodburn successfully completed his induction into the Group, assumed full operating responsibility for certain businesses and worked collaboratively with Ian King and the Board on a robust succession plan that has led to an agreed timetable for his transition to the role of Chief Executive.
   - Group Finance Director Peter Lynas delivered robust financial statements and results as well as achieving objectives relating to the Group's pension schemes and investor relations. He continues to work on reducing the extent of certain outstanding legacy financial issues against which provisions are held and have been reduced progressively.
   - President and Chief Executive Officer of BAE Systems, Inc. Jerry DeMuro successfully managed the underlying cost base of the US business, thereby improving future competitiveness, as well as achieving contract wins. He also met objectives concerning the strategic development of BAE Systems, Inc. and developing domestic and international portfolio positions. The majority of the US businesses met or exceeded plan, leading to BAE Systems, Inc. meeting stretch targets overall.

Annual remuneration report
continued

Long-Term Incentive Plan (LTIP) performance

Annual average EPS growth

Outperformance of performance conditions ending on 31 December 2016	Threshold	Maximum	Actual	Percentage of maximum achieved
2016 EPS requirement	48.1p	55.6p	40.1p	
Annual average EPS growth	5%	11%	<5%	0%

Relative TSR against comparator group

Outperformance of performance conditions ending on 31 December 2016	Threshold	Maximum	Actual	Percentage of maximum achieved
TSR against comparator group	76.4%	113.2%	49.1%	0%

The following awards had performance periods that ended on 31 December 2016:

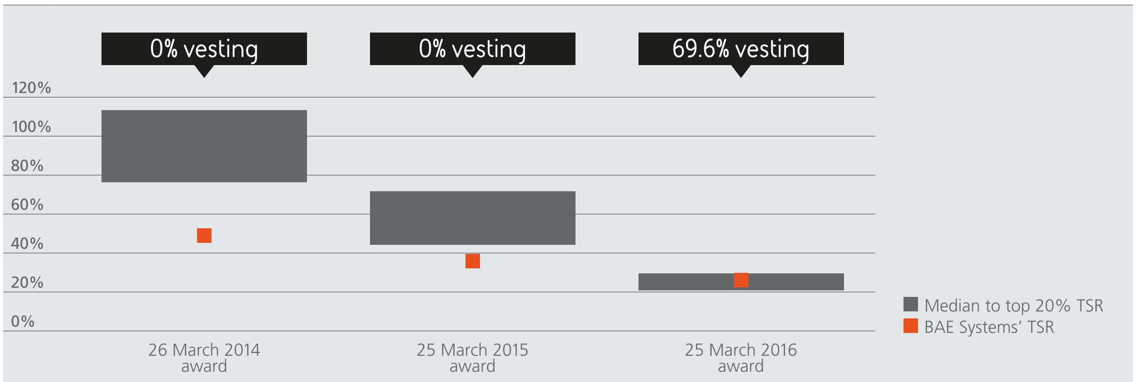
2014 Performance Share Plan (PSP)
- Performance conditions: half on relative TSR against comparator group, half on EPS growth of 5% to 11% per annum. The TSR performance condition ended on 31 December 2016 resulted in nil vesting and, accordingly, the TSR portion will lapse. The EPS growth was not achieved and, accordingly, this portion will lapse.

2014 Executive Share Option Plan (ExSOP2012)
- Performance condition: relative TSR against comparator group. The TSR performance condition ended on 31 December 2016 and the option will lapse as the performance condition was not met.

A summary of TSR performance to 31 December 2016 on outstanding TSR-related LTIP awards is illustrated in the chart below.

The dark grey boxes show the range of TSR required for 25% vesting to full vesting and the orange boxes show BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

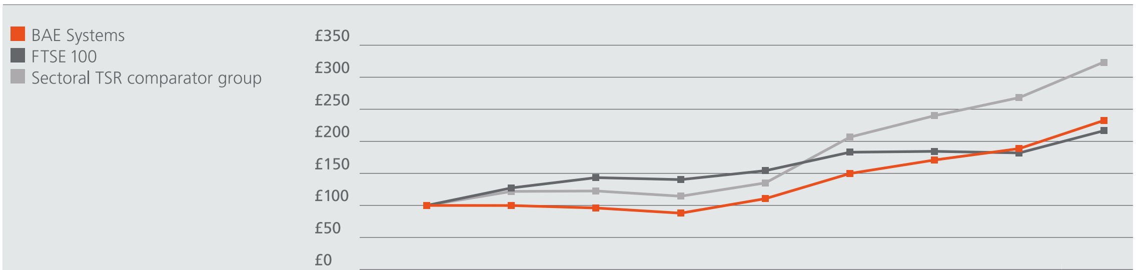
TSR performance under the TSR-related awards as at 31 December 2016



Total Shareholder Return (TSR) performance and Chief Executive pay

The graph below shows the value by 31 December 2016, on a TSR basis, of £100 invested in BAE Systems on 31 December 2008 compared with the value of £100 invested in the FTSE 100 index, including the effect of dividends. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity index of which BAE Systems is a constituent member and reflects the investment interests of our UK shareholder base. The equivalent data is shown for the sectoral TSR comparator group of other international defence companies which is of relevance to our international shareholder base.

Value at 31 December 2016 of £100 investment at 31 December 2008



Change in Chief Executive's remuneration over eight years	2008	2009	2010	2011	2012	2013	2014	2015	**2016**
Chief Executive's single figure (£'000)		4,030	4,810	4,613	2,574	2,499	3,519	2,929	**3,463**
Bonus paid as a percentage of maximum		83.0%	71.0%	68.6%	55.6%	53.4%	74.3%	72.4%	**82.3%**
LTI as a percentage of maximum vesting		65.5%	57.6%	44.3%	nil	nil	16.8%	nil	**nil**

Note: Total remuneration includes the value of share plans vesting that were granted prior to appointment as Chief Executive.

The percentage change from 2015 to 2016 in remuneration of the Chief Executive and average UK employee was as follows:

	Change in Chief Executive's remuneration %	Change in average UK employee[1] remuneration %
Salary	+2.0	+2.9
Benefits	+3.5	+2.9
Bonus	+15.9	+12.9

1. The BAE Systems UK employee population has been chosen as this employee comparator group reflects the local employment conditions of the Chief Executive for the purpose of this comparison.

Pay ratio of Chief Executive to average employee

The ratio of remuneration of the Chief Executive to the average employee of the entire Group over the last three years was as follows:

	2014	2015	2016
Chief Executive's remuneration[1] (£'000)	3,519	2,929	3,463
Average employee remuneration[2] (£'000)	58	62	67
Ratio	60:1	47:1	52:1

1. The Chief Executive's remuneration is calculated on the same basis as the single figure of remuneration table.
2. Average employee remuneration is based on staff costs calculated on the same basis as note 3 to the Group accounts, excluding social security costs and US healthcare costs.

The Committee is mindful of the relationship between Chief Executive remuneration and remuneration of the wider BAE Systems employee population. Therefore, in line with our commitment to transparency, the table above provides the ratio of remuneration of the Chief Executive to the average employee of the Group for the past three years. As can be seen, the ratio has typically been around 50:1, with the ratio being higher in 2014 as a result of the partial vesting of Long-Term Incentive awards in that year. The ratio could range from around 20:1 to 100:1 depending on the level of performance against the measures which drive the Annual and Long-Term Incentive Plans.

Annual remuneration report
continued

Relative importance of spend on pay

The following charts set out underlying EBITA[1], amounts paid in returns to shareholders, total employee costs and average headcount for the years ended 31 December 2015 and 2016.

Underlying EBITA[1] (£m)

Returns to shareholders (£m)

Total employee costs (£m)

Average headcount[3] ('000)

1. Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 25).
2. Includes share buyback of £7m.
3. Excluding share of equity accounted investments.

Pension entitlements

Total pension entitlements

Director	Age	Normal retirement age	Accrued benefit at 1 January 2016[1,2,3,4] £ per annum	Accrued benefit at 31 December 2016[1,2,3,4] £ per annum	Figures included in the remuneration table on page 85: Added pension value received in the year from defined benefit scheme[2] £	Added pension value received in the year from defined contribution scheme £	Total £
Ian King	60	62	826,209	861,168	612,894	–	612,894
Charles Woodburn	45	65	–	7,270	–	–	–
Peter Lynas	58	62	436,487	459,220	404,517	–	404,517
Jerry DeMuro	61	65	51,291	99,884	–	12,030	12,030

1. Ian King and Peter Lynas have accrued defined benefit pensions which are reduced if they are taken before normal retirement age. In addition, a longevity adjustment factor is applied to their pension accrued after 5 April 2006 to mitigate against life expectancy changes. Their figures allow for the current factors in force, whereas in practice the factors are updated annually and those in force at retirement will be applied.
2. The defined benefit figure includes both funded and unfunded arrangements for Ian King and Peter Lynas.
3. Peter Lynas' accrued benefit will be restated next year to allow for the impact of his divorce, once finalised. However, the added pension value received in 2016 will be unaffected.
4. Accrued benefit for Ian King and Peter Lynas is annual pension payable on retirement. Accrued benefit for Jerry DeMuro is the total value of his Section 401(k) account, including both employee and company contributions as well as investment returns. Accrued benefit for Charles Woodburn is the total value of his defined contribution account, including employee contributions and investment returns.

The above table has been subject to audit.

Ian King and Peter Lynas are members of the BAE Systems Executive Pension Scheme (ExPS) and the BAE Systems 2000 Pension Plan (2000 Plan) which together provide a pension for executive directors payable at 62 of 1/30th of three-year average final salary for each year of service subject to the payment of members' contributions (currently 8%). Benefits paid prior to age 62 will be subject to actuarial reduction.

The ExPS tops up the underlying employee plan to provide a target benefit for executive directors payable from normal retirement age of 1/30th of Final Pensionable Pay (FPP) for each year of ExPS pensionable service (subject to a maximum of two-thirds of FPP). FPP is defined as annual base salary averaged over the last 12 months prior to leaving service in respect of service accrued to 5 April 2006 and 36 months prior to leaving in respect of service from 6 April 2006. The ExPS also provides a lump sum death-in-service benefit equal to four times base salary at date of death, and a spouse's death-in-service pension equal to two-thirds of the prospective pension at normal retirement age. Spouses' pensions are also payable upon death in retirement and death after leaving the Company's employment with a deferred pension. Once in payment, pensions are increased annually by the rise in the Retail Prices Index subject to a maximum increase of 5% per year in respect of pre-6 April 2006 service and 2.5% per year in respect of service from 6 April 2006. Ian King and Peter Lynas joined the ExPS in 1999.

The 2000 Plan provides a pension of 1/50th of Final Pensionable Earnings (FPE) for each year of pensionable service, payable from a normal retirement age of 65 and members pay contributions of 8% of Pensionable Earnings. FPE under the 2000 Plan is the best consecutive three-year average of base salary and bonus in the ten Plan Years prior to leaving, less an offset for State pensions. The Company decided in 2006 to limit pensionable bonuses in the 2000 Plan in the 2006/07 Plan Year to 20% of base salary and to 10% of base salary for the 2007/08 Plan Year and thereafter. However, there is a guarantee that the FPE figure for benefits in respect of service prior to 6 April 2007 will not be less than the FPE figure at 5 April 2007 to ensure that employees do not lose the benefit of contributions paid on past bonuses. Ian King and Peter Lynas have 33 years and 6 months and 31 years and 2 months service, respectively, in the 2000 Plan.

The review of pension policies carried out in 2010 by the Committee concluded that the pension benefits should continue to be based on the Company's registered pension schemes and that, in appropriate circumstances, the Company will continue to have the option to offer an unfunded pension promise so as to mitigate the impact of further reductions to the Lifetime Allowance and the impact of the reduced Annual Allowance. Ian King and Peter Lynas were given the choice to remain in the current arrangement and pay the increased tax or to take an unfunded promise; they both elected for the latter. The Committee has decided that in cases where the Company is to pay an unfunded promise, executives will be given the choice to commute some or all of the benefit for a taxable lump sum, or take it as pension. Where an unfunded pension is taken, ten years after retirement, the executive will be given a further opportunity to commute the residual value of the unfunded pension for a lump sum.

Therefore, Ian King's and Peter Lynas' individual total pensions are the sum of their 2000 Plan benefits plus the top-up from the ExPS, most of which is provided through the unfunded promise referred to above.

Jerry DeMuro participates in a Section 401(k) defined contribution arrangement set up for US employees in which the company will match his contributions up to a maximum contribution of 6% of salary, up to US regulatory limits (2016 $15,900; 2017 $16,200). In 2016, the company paid contributions of $14,867 into this arrangement.

Charles Woodburn participates in the BAE Systems Executive Pension Scheme Defined Contribution Retirement Plan (EPS DCRP), which is a defined contribution arrangement for senior executives. Charles Woodburn contributes the maximum £10,000 per annum into the EPS DCRP arrangement as permitted by the Annual Allowance limit and a 19% salary supplement is paid in lieu of the Company contributions.

Executive director changes

As announced by the Company on 22 February 2017, the following arrangements will apply in relation to Ian King when he retires as a director and ceases employment on 30 June 2017. The arrangements are strictly in accordance with the Company's remuneration policy, approved by shareholders at the AGM on 7 May 2014, and the rules of the Company's 2000 Pension Plan and Executive Pension Scheme outlined in the 2015 Annual Report.

(a) Ian King's retirement will constitute early retirement with Company consent for share plan and pension purposes and, accordingly:
  (i) he will be entitled to an immediate pension. Under the rules of the 2000 Pension Plan and Executive Pension Scheme, a pension of 1/30th of three-year final average salary for each year of service subject to the payment of members' contributions (currently 8%) is payable at 62 years of age. Benefits paid prior to age 62 are subject to actuarial reduction, currently a reduction of 4% to annual benefits for each year that retirement takes place prior to age 62, with proportionate reductions applied in respect of part years. Mr. King will be 61 at the date of his retirement and his pension payments will be reduced accordingly;
  (ii) unvested share awards and options under the Company's Long-Term Incentive Plan will vest at the normal vesting date, subject to testing of the relevant performance conditions at the end of the normal performance period. Share awards will be reduced pro rata on the basis of complete months from the grant date to 30 June 2017. Any share options that vest will remain exercisable for a period of six months from the vesting date;
  (iii) unvested deferred bonus awards will be preserved and will vest at the normal vesting dates; and
  (iv) vested share options awarded in 2012 under the Executive Share Option Plan will remain available to exercise in the six-month period from 1 July 2017. The award will lapse if not exercised during this period.

(b) He will continue to be covered by the Company's Directors' and Officers' insurance policy and his current director's indemnification arrangements will remain in force;

(c) He will continue to be bound by those provisions of his service agreement which continue to apply following cessation of employment, including post-termination restrictive covenants and confidentiality provisions;

(d) He will be eligible for an Annual Incentive payment for 2017, determined by the Remuneration Committee, based on an assessment of individual and Company performance. Any bonus will be pro-rated for his six months of service during 2017 and will be paid at the normal date following the end of the 2017 financial year. One-third of the net bonus will be compulsorily deferred into shares in the normal way;

(e) No award will be granted under the Long-Term Incentive Plan in 2017;

(f) No termination payment will be payable; and

(g) Taxable benefits comprising the provision of a car allowance and the private use of a chauffeur-driven car will cease from 30 June 2017.

On becoming Chief Executive, Charles Woodburn's base salary will increase to £875,000 per annum. All other provisions of his remuneration package will be as set out in the Company's remuneration policy in respect of the Chief Executive role.

Annual remuneration report continued

External directorships

Fees retained in 2016 by executive directors during the period in which they served in that capacity in respect of non-executive directorships were: Peter Lynas £76,850 in respect of his directorship of SSE plc; and Jerry DeMuro $58,333 in respect of his directorship of Aero Communications, Inc. These amounts are not included in the remuneration table on page 85. Ian King's non-executive directorship of Schroders plc commenced on 1 January 2017 and, therefore, there are no fees to disclose for 2016.

Share interests

Scheme interests awarded during the financial year

Scheme	Type of interest	Date of grant	Number of shares	Basis of award	Face value of award[1] £	Exercise price £	Date to which performance is measured	Performance condition	Percentage of interests receivable if minimum performance achieved
Ian King									
LTIP PS[TSR]	Performance Shares/nil cost option	23.03.16	246,165	125% of salary	1,227,871	nil	Three years to 31.12.18	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	23.03.16	246,166	125% of salary	1,227,876	nil	Three years to 31.12.18	EPS/secondary financial measure	25%
LTIP SO	Share option	23.03.16	590,797	300% of salary	2,946,895	4.99	Three years to 31.12.18	TSR/secondary financial measure	25%
Charles Woodburn									
LTIP PS[TSR]	Performance Shares/nil cost option	06.09.16	334,833	See note 2 below	1,859,997	nil	Three years to 30.06.19	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	06.09.16	334,833	See note 2 below	1,859,997	nil	Three years to 31.12.18	EPS/secondary financial measure	25%
LTIP SO	Share option	06.09.16	405,040	300% of salary[2]	2,249,997	5.56	Three years to 30.06.19	TSR/secondary financial measure	25%
Peter Lynas									
LTIP PS[TSR]	Performance Shares/nil cost option	23.03.16	123,060	107.5% of salary	613,823	nil	Three years to 31.12.18	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	23.03.16	123,060	107.5% of salary	613,823	nil	Three years to 31.12.18	EPS/secondary financial measure	25%
LTIP SO	Share option	23.03.16	343,424	300% of salary	1,712,999	4.99	Three years to 31.12.18	TSR/secondary financial measure	25%
Jerry DeMuro									
LTIP PSP[TSR]	Performance Shares	23.03.16	168,203	121% of salary	838,997	n/a	Three years to 31.12.18	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares	23.03.16	168,203	121% of salary	838,997	n/a	Three years to 31.12.18	EPS/secondary financial measure	25%
LTIP SO	Share option	23.03.16	542,143	390% of salary	2,704,209	4.99	Three years to 31.12.18	TSR/secondary financial measure	25%
LTIP RS	Retention	23.03.16	139,011	100% of salary	693,387	n/a	n/a	n/a	n/a

1. The value of the award is calculated on the date of grant by reference to the middle market quotation at the close of the preceding day.
2. The 2016 award of Performance Shares made to Charles Woodburn comprises two elements as reported in the 2015 Annual remuneration report, these being: (i) his annual grant of Performance Shares equal to 230% of salary; and (ii) a one-off grant of Performance Shares equal to 266% of salary as part of the Company's arrangements to buy out certain bonus and long-term incentives previously awarded by Charles Woodburn's former employer and forfeited as a consequence of joining BAE Systems. The Share Option figure represents his annual grant, also as previously reported in the 2015 Annual remuneration report.

Key: LTIP – Long-Term Incentive Plan. PS – Performance Shares. SO – Share Options. RS – Restricted Shares.

Note: Performance Shares and Restricted Shares – Shares under award attract dividends prior to vesting. Performance Shares are intended to be free share awards and are structured as a nil cost option to give the participant more flexibility as to the timing of the benefit. For the US executive director, awards of Performance Shares are classified as contingent awards (rather than share options) and are deliverable on the third, fourth and fifth anniversary of grant, subject to attainment of the performance condition.

The table above has been subject to audit.

Description of share plans and summary of performance conditions

PSP/LTIP Performance Shares

Shares under award vest after satisfaction of the three-year performance condition. Shares under award attract dividends prior to vesting. Awards that vest are exercisable in three equal tranches between the third and seventh anniversary of vesting (being capable of exercise on a phased basis from the third, fourth and fifth anniversary of grant). For US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved. Since 2015, shares have been awarded under the LTIP (a single umbrella plan) that was approved at the 2014 AGM as detailed on page 101 and are termed 'Performance Shares'.

Awards made to the UK executive directors since 2008, and to date to the current US executive director, have been weighted 50% on the PSP^{EPS} performance condition and 50% on the PSP^{TSR} performance condition. The TSR comparator groups are shown below.

Plan	Performance condition
LTIP PS^{EPS}	For awards made from 2015, rate of average annual EPS growth over the three-year performance period, with 25% vesting at 3% average growth per annum, 50% vesting at 5% average growth per annum and 100% vesting at 7% average growth per annum, with vesting on a straight-line basis between these parameters. Awards will not vest unless the Board is satisfied that there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; order book; risk; and project performance.
PSP^{EPS}	Pre-2015, rate of average annual EPS growth over the three-year performance period, with nil vesting at 5% average growth per annum and 100% vesting at 11% average growth per annum, with vesting on a straight-line basis between these two parameters.
PSP^{TSR}/ LTIP PS^{TSR}	The proportion of the award capable of exercise is determined by: (i) for awards made up to and including 2015, the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. For awards made from 2016, 50% of the TSR measure on the current peer comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. Under both the sectoral and FTSE 100 comparator groups, no shares vest if the Company's TSR is below the top 50% of TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters; and (ii) whether there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA[1]; order book; turnover; risk; and project performance.

1. Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense.

The TSR peer comparator group for awards from 2016 comprises:

Cobham	Leonardo[2]	SAIC
General Dynamics	Lockheed Martin	Thales
Harris Corporation	Meggitt	United Technologies
L-3 Communications	Northrop Grumman	
Leidos	Raytheon	

The TSR comparator group for awards from 2012 to 2015 comprises:

Cobham	Leonardo[2]	Raytheon
General Dynamics	Lockheed Martin	SAIC
ITT Exelis[3]	Meggitt	Thales
L-3 Communications	Northrop Grumman	United Technologies

2. Formerly named Finmeccanica.
3. ITT Exelis is now part of Harris Corporation.

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ExSOP2012/LTIP Share Options

Options are normally exercisable between the third and tenth anniversary of their grant, subject to the performance condition set out below being achieved. Since 2015, shares have been awarded under the single umbrella plan (the Long-Term Incentive Plan) that was approved at the 2014 AGM as detailed on page 101 and are termed 'Share Options'. Awards made from 2015 are subject to a further two-year clawback period after the initial three-year vesting period.

Plan	Performance condition
ExSOP2012/ LTIP SO	For awards made up to and including 2015, the proportion of the award capable of exercise is determined by the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. For awards made from 2016, 50% of the TSR measure on the current peer comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. Under both the sectoral and FTSE 100 comparator groups, no shares vest if the Company's TSR is below the top 50% of TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters.

RSP/LTIP Restricted Shares

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US. The shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date). Shares under award attract dividends prior to vesting. Since 2015, shares have been awarded under the single umbrella plan that was approved at the 2014 AGM as detailed on page 101 and are termed 'Restricted Shares'. Awards made from 2015 are subject to a further two-year clawback period after the initial three-year vesting period.

Statement of directors' shareholdings and share interests

Minimum Shareholding Requirement (MSR)

Executive directors are compulsorily required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and Long-Term Incentive schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

The following table sets out MSR Initial Value and Subsequent Value:

	Initial Value	Subsequent Value
Ian King	150%	300%
Charles Woodburn	100%	200%
Peter Lynas	100%	200%
Jerry DeMuro	175%	350%

Ian King and Peter Lynas were both in excess of their 'Subsequent Value' MSR at 31 December 2016. Jerry DeMuro joined the Board in 2014 and his personal holding of shares in the Company at 31 December 2016 stood at 53%. The higher MSR values applicable to Jerry DeMuro recognise the higher LTI opportunity and broader US market practice. Charles Woodburn joined the Board in May 2016 and his personal shareholding in the Company at 31 December 2016 stood at 21%.

There are no shareholding requirements for the Chairman or the non-executive directors.

Share interests as at 31 December 2016

The interests of the directors, who served during the year ended 31 December 2016, in the shares of BAE Systems plc, or scheme interests in relation to those shares, were as follows:

	Shares	Scheme interests: Options and awards over shares				
		Share awards with performance	Share awards without performance	Share options with performance	Share options with performance, vested but unexercised	Total scheme interests
Sir Roger Carr	92,224	–	–	–	–	–
E P L Corley[1]	10,000	–	–	–	–	–
J DeMuro	72,250	968,163	400,067	1,560,265	–	2,928,495
H Green	–	–	–	–	–	–
C M Grigg	24,555	–	–	–	–	–
I G King	1,862,821	–	–	3,364,475	256,279	3,620,754
P J Lynas	206,263	–	–	1,811,726	–	1,811,726
P Rosput Reynolds	25,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–
C N Woodburn[2]	26,654	–	–	1,074,706	–	1,074,706

1. Appointed to the Board on 1 February 2016.
2. Appointed to the Board on 9 May 2016.

The above table has been subject to audit.

The interests of directors include those of their connected persons. The shares held by Paula Rosput Reynolds are represented by 6,300 American Depositary Shares. Details of the share interests in options and awards held by the executive directors as at 31 December 2016 are given on page 96 and details of share options exercised in 2016 are given on page 97.

Awards under the PSP and Performance Shares granted under the LTIP are classified as share awards with performance for the US executive director and as share options with performance for the UK executive directors.

Since 31 December 2016, Ian King has acquired an additional 65 shares under the Partnership and Matching shares elements of the Share Incentive Plan and Charles Woodburn has acquired an additional 73 shares under the Partnership and Matching shares elements of the Share Incentive Plan so that their beneficial shareholdings at the date of this report stood at 1,862,886 and 26,727, respectively.

There have been no changes in the interests of the remaining directors in the shares of BAE Systems plc between 31 December 2016 and the date of this report.

Since the date of this report, Ian King has exercised an option over the 256,279 shares shown as vested but unexercised in the table above; the resulting shares were disposed of thus his beneficial shareholding as at 23 February 2017 remained at 1,862,886. In addition, Charles Woodburn has acquired a further 46,569 shares taking his beneficial shareholding as at 24 February 2017 to 73,296 shares; this acquisition completed the purchase of shares required to be made from the cash payment referred to in paragraph 6(i) on page 86.

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Breakdown of scheme interests: Options and awards held as at 31 December 2016

Ian King

	31 December 2016	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP TSR	**17,797**[1]	29.03.12	nil	29.03.17
PSP TSR	**292,542**[2]	26.03.14	nil	26.03.17
PSP EPS	**292,543**[2]	26.03.14	nil	26.03.17
LTIP PS TSR	**221,900**[3]	25.03.15	nil	25.03.18
LTIP PS EPS	**221,901**[3]	25.03.15	nil	25.03.18
LTIP PS TSR	**246,165**[3]	23.03.16	nil	23.03.19
LTIP PS EPS	**246,166**[3]	23.03.16	nil	23.03.19
	1,539,014			
ExSOP 2012	**256,279**[4]	29.03.12	3.01	29.03.15
ExSOP 2012	**702,102**[2]	26.03.14	4.12	26.03.17
LTIP SO	**532,562**[3]	25.03.15	5.43	25.03.18
LTIP SO	**590,797**[3]	23.03.16	4.99	23.03.19
	2,081,740			

Peter Lynas

	31 December 2016	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP TSR	**10,090**[1]	29.03.12	nil	29.03.17
PSP TSR	**142,636**[2]	26.03.14	nil	26.03.17
PSP EPS	**142,637**[2]	26.03.14	nil	26.03.17
LTIP PS TSR	**110,373**[3]	25.03.15	nil	25.03.18
LTIP PS EPS	**110,373**[3]	25.03.15	nil	25.03.18
LTIP PS TSR	**123,060**[3]	23.03.16	nil	23.03.19
LTIP PS EPS	**123,060**[3]	23.03.16	nil	23.03.19
	762,229			
ExSOP 2012	**398,055**[2]	26.03.14	4.12	26.03.17
LTIP SO	**308,018**[3]	25.03.15	5.43	25.03.18
LTIP SO	**343,424**[3]	23.03.16	4.99	23.03.19
	1,049,497			

Jerry DeMuro

	31 December 2016	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP TSR	**169,258**[2]	26.03.14	n/a	26.03.17
PSP EPS	**169,258**[2]	26.03.14	n/a	26.03.17
LTIP PS TSR	**146,620**[3]	25.03.15	n/a	25.03.18
LTIP PS EPS	**146,621**[3]	25.03.15	n/a	25.03.18
LTIP PS TSR	**168,203**[3]	23.03.16	n/a	23.03.19
LTIP PS EPS	**168,203**[3]	23.03.16	n/a	23.03.19
	968,163			
ExSOP 2012	**545,543**[2]	26.03.14	4.12	26.03.17
LTIP SO	**472,579**[3]	25.03.15	5.43	25.03.18
LTIP SO	**542,143**[3]	23.03.16	4.99	23.03.19
	1,560,265			
RSP	**139,882**	26.03.14	n/a	26.03.17
LTIP RS	**121,174**	25.03.15	n/a	25.03.18
LTIP RS	**139,011**	23.03.16	n/a	23.03.19
	400,067			

Charles Woodburn

	31 December 2016	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS TSR	**334,833**[3]	06.09.16	nil	06.09.19
LTIP PS EPS	**334,833**[3]	06.09.16	nil	06.09.19
	669,666			
LTIP SO	**405,040**[3]	06.09.16	5.56	06.09.19

1. Exercisable on the fifth anniversary of grant.
2. The outstanding option or award will lapse after the end of the financial year having not met the full performance condition.
3. Subject to a performance condition that is yet to be tested.
4. Vested but unexercised.

Options exercised during 2016

Ian King

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP[TSR]	17,797	nil	29.03.12	11.05.16	4.92

The PSP option exercised by Ian King attracted reinvested dividends which equated to an additional 2,825 shares.

Peter Lynas

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP[TSR]	10,090	nil	29.03.12	17.06.16	4.84

The PSP option exercised by Peter Lynas attracted reinvested dividends which equated to an additional 1,601 shares.

The tables on page 96 and above have been subject to audit.

Performance conditions

Performance conditions for the LTIP, PSP and ExSOP[2012] are detailed on pages 93 and 94.

Statement of voting

Shareholder voting on the resolutions to approve the Directors' remuneration policy put to the 2014 AGM and the Annual remuneration report put to the 2016 AGM was as follows:

Directors' remuneration policy

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,141,307,622	92.95	162,437,084	7.05	2,303,744,706	19,304,785

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Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,321,944,825	94.89	125,150,986	5.11	2,447,095,811	1,125,734

Annual remuneration report
continued

Remuneration Committee composition and advisers

The Committee members comprise Paula Rosput Reynolds (Chairman), Elizabeth Corley (appointed to the Committee on 1 February 2016) and Nick Rose. Chris Grigg stepped down from the Committee on 16 February 2016. Advisers to the Remuneration Committee are shown below.

Adviser	Services provided	Appointment	Governance	Fees
Willis Towers Watson (WTW)	Appointed in May 2016 to advise the Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	WTW engages directly with the members of the Committee. The Committee is aware that WTW provides a variety of other services to the Company, including corporate risk management advice and insurance brokerage services. WTW also provides a range of HR consultancy services related to human capital management and employee benefits. WTW is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£79,140 Fee basis: Hourly
Kepler (part of Mercer)	Until May 2016, advised Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	Kepler engaged directly with the members of the Committee. Kepler did not undertake any other work for the Company. Kepler is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£9,263 Fee basis: Hourly
Linklaters	Provided legal services, principally regarding remuneration policy regulations.	By the Company with the approval of the Committee.	Only provides legal compliance, legal drafting and review services, and does not advise the Committee. The Committee is aware that Linklaters is one of a number of legal firms that provides legal advice and services to the Company on a range of matters. Linklaters is regulated by the Law Society.	£6,598 (in respect of services provided to the Committee) Fee basis: Hourly
PricewaterhouseCoopers (PwC)	Provides information on market practice in relation to different aspects of remuneration, market trends and benchmarking of the remuneration packages for the executive population.	By the Company at the request of the Committee.	The Committee is aware that PwC provides a variety of other services to the Company, including tax and pensions advice. PwC also provides a range of consultancy services. The nature of the advice provided to the Committee is primarily related to market comparator information and does not include advice on the design of remuneration policy. PwC is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£75,500 (in respect of services provided to the Committee) Fee basis: Hourly
New Bridge Street (part of Aon Hewitt)	Advises on the TSR outcomes as required for assessing the performance condition under the Performance Share Plan and LTIP 2014.	By the Company.	The Committee is aware that New Bridge Street provides a variety of other HR-related services to the Company. The nature of the advice provided to the Committee is limited to factual information concerning the performance of the Company's shares. New Bridge Street is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£10,850 (in respect of services provided to the Committee) Fee basis: Fixed fee

During the year, the Committee received material assistance and advice on remuneration policy from the Group Human Resources Director, Lynn Minella, and the Human Resources Director, Reward, Paul Farley. Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

Non-Executive Directors' Fees Committee

The non-executive directors' fees are set by the Non-Executive Directors' Fees Committee which comprises Sir Roger Carr (Chairman), Philip Bramwell (Group General Counsel), Jerry DeMuro and Ian King.

Directors' remuneration policy
for approval at the 2017 Annual General Meeting

This Directors' remuneration policy (the Policy) will take legal effect from the conclusion of the 2017 Annual General Meeting (AGM) subject to shareholder approval at the 2017 AGM.

The Remuneration Committee (the Committee) considers remuneration policy annually to ensure that it remains aligned with business needs and is appropriately positioned relative to the market. However, in the absence of exceptional or unexpected circumstances which may necessitate a change to the Policy, there is currently no intention to revise the Policy more frequently than every three years. We use target performance to estimate the total potential reward and benchmark it against reward packages paid by BAE Systems' competitors.

The Policy is to set base salary with reference to the relevant market-competitive level. Actual total direct reward reflects the performance of the individual and the Company as a whole. The aim is to deliver an overall remuneration package for executive directors which provides an appropriate balance between short-term and long-term reward and between fixed and variable reward as described in the table below.

Whilst our Long-Term Incentive Plan provides the Committee with discretion in respect of vesting outcomes that affect the actual level of reward payable to individuals, as explained on page 102, such discretion would only be used in exceptional circumstances and, if exercised, disclosed at the latest in the report on implementation of the Policy (i.e. the Annual remuneration report) for the year in question.

Changes compared to the policy approved at the 2014 AGM

The Policy contains no components which were not in the remuneration policy approved at the 2014 AGM. However, the material changes from the policy approved in 2014 are summarised below with the supporting rationale provided in the Remuneration Committee Chairman's letter on pages 79 to 81:

Salary
- Clarity on cap on salary increases.

Annual incentive
- Introduction of separate maximum for Chief Operating Officer.
- Introduction of limits for new executive director role.
- Incorporation of malus and clawback mechanisms.

Long-Term Incentives (LTI)
- Introduction of reasonableness discretion.
- Introduction of separate maximum for Chief Operating Officer.
- Introduction of limits for new executive director role.
- Clarity on flexibility to vary weightings of different award types and the associated impact on opportunity levels subject to the parameters set out.
- Incorporation of malus and clawback mechanisms.
- Introduction of two-year holding period for shares acquired on vesting of awards to non-US directors.
- Introduction of Earnings per Share (EPS) alongside Total Shareholder Return (TSR) on share options with equal weighting.
- Removal of Share Options for US executive director and redistribution into Performance Shares and Restricted Shares to maintain current Expected Value.
- Increase in Minimum Shareholding Requirement for US executive director.

Pension
- Participation in executive defined contribution retirement plan (or cash equivalent) introduced as default pension vehicle for new directors.
- Inclusion of salary supplement as vehicle to offset impact of Lifetime Allowance and/or Annual Allowance.

Non-executive directors' fees
- Introduction of maximum for Chairman's fees and benefits.

Directors' remuneration policy continued

Executive directors' policy table

Base salary

Purpose and link to strategy
Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.

Operation
Salaries are reviewed annually. Business and individual performance, skills, the scope of the role and the individual's time in the role are taken into account when setting and assessing salaries, as is market data for similar roles in the relevant market comparator group.

The comparator group for UK executive directors is comprised of selected companies from the FTSE 100 and is constructed to position BAE Systems around the median in terms of market capitalisation. For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group is drawn from companies in the US aerospace and defence sectors, together with similar organisations in the general industry sector where BAE Systems, Inc. is positioned at the median of the comparator group by reference to revenue size.

Maximum opportunity
When considering salary increases for the executive directors in their current roles, the Committee considers the general level of salary increase across the Group and in the relevant external market.

Actual increases for the executive directors in their current roles will generally not exceed the average percentage increase for employees as a whole, taking account of the level of movement within the relevant UK/US comparator group.

As a maximum, in exceptional circumstances (such as a material increase in job size or complexity while performing the same role, or a recently appointed executive director where the salary is positioned low against the market), the increase will not exceed 10% in any single year for executive directors performing the same role. If an individual's role changes then a salary increase above 10% may be awarded in any single year to position their salary appropriately in accordance with the base salary principles described under 'Operation' above. As a matter of policy, no new executive director role will have a salary greater than the Chief Executive at that time.

Performance metrics used, weighting and time period applicable
None.

Annual incentive

Purpose and link to strategy
Drive and reward annual performance of individuals and teams on both financial and non-financial metrics, including leadership behaviours in order to deliver sustainable growth in shareholder value.

Compulsory deferral into shares increases alignment with shareholder interests.

Operation
The annual incentive is driven off in-year financial performance, corporate responsibility and other non-financial objectives measured at the Group and individual level.

One-third of the total annual incentive amount is subject to compulsory deferral for three years in BAE Systems shares without any matching.

A malus mechanism may be applied to any bonus, and a clawback mechanism may be applied to the deferred bonus shares until up to the end of the three-year deferral period, in respect of 2015 or subsequent years where:

- the Company is entitled to terminate employment for cause or the participant has engaged in misconduct (including breach of policy) which gives rise to other disciplinary sanction;
- the results of the Company and/or relevant business or businesses for any period have been restated or subsequently appear materially inaccurate or misleading; and/or
- any Group company or business unit has made a material financial loss.

Cash dividends are payable to the participants on the shares during this three-year deferral period.

Executive directors' policy table continued

Annual incentive continued

Maximum opportunity
Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary

Chief Operating Officer: 200% of salary

Group Finance Director: 160% of salary

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

The pay-out for maximum performance is double the payout for on-target performance. The pay-out for target performance is half of the respective maximum percentages above. The pay-out for achieving a threshold performance is 40% of the payout for on-target performance (i.e. 20% of maximum), with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.

Performance metrics used, weighting and time period applicable
Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year and other objectives designed to support the Group's strategy. Metrics, which will include financial and non-financial metrics as well as the achievement of personal objectives, will be determined and weighted each year according to business priorities. 75-80% will relate to financial metrics.

Metrics and weightings to be determined annually. Proposed metrics and weightings applicable in 2017:

Group EPS – 40%

Group cash – 25%

Order intake – 15%

Safety – 5%

Personal objectives designed to support the Group's strategy – 15%

See notes 4 and 5 on page 106 regarding the selection and weighting of performance metrics.

Notwithstanding performance against the applicable metrics, all bonus payments are at the discretion of the Committee, which will be based on an assessment of the individual's personal contribution to business performance over the relevant year and leadership behaviours demonstrated in making that contribution, relative to others.

Long-Term Incentives (LTI)

Operation
Long-term incentives will operate under the BAE Systems Long-Term Incentive Plan approved by shareholders at the 2014 AGM.

The size of awards granted is based on a percentage of salary, which is divided by the share price to determine the number of shares subject to the award.

Dividend equivalents in respect of vested shares may be paid at the time of vesting (or exercise, in the case of options) and are not taken into account when determining individual limits.

A malus and clawback mechanism may be applied, until two years after vesting, or if sooner, the fifth anniversary of grant, or the occurrence of certain corporate events, to all awards granted on or after 25 March 2015 where:

- the Company is entitled to terminate employment for cause or the participant has engaged in misconduct (including breach of policy) which gives rise to other disciplinary sanction;
- the results of the Company and/or relevant business or businesses for any period have been restated or subsequently appear materially inaccurate or misleading;
- any Group company or business unit has made a material financial loss; and/or
- the measurement of any performance condition does not reflect the actual performance of the Company over the performance period.

The Committee will establish the targets for each measure at the start of each performance period based on Group projections and market expectations for the business. The performance conditions for previous awards are described in the Annual remuneration report.

Awards and performance conditions can be adjusted to take account of variations of share capital and other transactions or events.

On a change of control or similar transaction, awards generally will vest to the extent performance conditions are then satisfied (if applicable) and then be pro-rated to reflect the acceleration of vesting unless the Committee decides otherwise. Alternatively, awards may be exchanged for equivalent awards over shares in the acquiring company.

The share plan rules may be amended from time-to-time by the Committee in certain circumstances including minor changes for administrative, tax or other regulatory purposes.

Subject to this Policy, performance conditions of awards already granted may be amended in accordance with their terms or if anything happens which causes the Committee reasonably to consider it appropriate to do so.

Performance metrics used, weighting and time period applicable
See notes 4 and 5 on page 106 regarding the selection and weighting of performance metrics.

Directors' remuneration policy
continued

Executive directors' policy table continued

Long-Term Incentives (LTI) continued

Maximum opportunity
Over the lifetime of this Policy, the Committee will have discretion to vary the weighting of different types of awards within the framework set out below, but the overall LTI Expected Value (EV) will remain the same (assuming the LTI EV is calculated as 50% of face value for Performance Shares, 20% of face value for Share Options and 100% of face value for Restricted Shares):

– UK executive directors' awards will consist of a mix of Performance Shares and Share Options (with Share Options comprising no more than 50% of overall LTI EV).
– US executive directors' awards will consist of a mix of Performance Shares and Restricted Shares (with Restricted Shares comprising no more than 50% of overall LTI EV).

Performance metrics used, weighting and time period applicable
See below in relation to Performance Shares and Share Options.

In addition to the primary performance tests set out below, the Committee confirms and recognises its obligation to judge the overall reasonableness of the rewards received relative to the overall business actions and results achieved. When determining the final performance condition outcome under Performance Share and Share Option awards, the Committee will have discretion over the number of awards vesting in light of other important factors in the business (reasonable discretion). The discretion may result in vesting of awards going upwards (subject to maximum 100% vesting of awards) as well as downwards. Any factors will be properly considered as they arise and any discretion to the calculated results will be applied in a highly disciplined manner and the rationale and impact will be reported transparently. The use of reasonableness discretion would apply to LTI awards granted to executive directors after the commencement of this Policy.

See notes 4 and 5 on page 106.

Long-Term Incentives – Performance Shares

Purpose and link to strategy
Drive and reward delivery of sustained long-term EPS and TSR performance aligned to the interests of shareholders.

Operation
For non-US executive directors, awards, typically in the form of nil-cost options, will vest subject to performance and service conditions on the fifth anniversary of grant. These will be exercisable between the fifth and tenth anniversary of grant or such shorter period as may be specified by the Committee.

For US executive directors, awards are delivered as conditional share awards (RSUs). To maintain the competitiveness of the LTI offering in the US, awards will vest automatically on the third, fourth and fifth anniversary of grant, subject to performance conditions.

Policy maximum opportunity
Award levels applicable to UK executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Share Options) are as follows:

Chief Executive: 250% of salary

Chief Operating Officer: 230% of salary

Group Finance Director: 215% of salary

Award levels applicable to US executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Restricted Shares) are as follows:

President and Chief Executive Officer of BAE Systems, Inc.: 298% of salary

Note the percentages above could be exceeded if the LTI EV weightings were to be varied (see above).

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

Executive directors' policy table continued

Long-Term Incentives – Performance Shares continued

Performance metrics used, weighting and time period applicable
Metrics and weightings will be as follows (subject to the Committee's ability to adjust as set out below):

- 50% of award based on TSR relative to one or more appropriate comparator groups over the three-year performance period as selected by the Committee at the time of grant:
  - Vesting of each comparator group is determined as: nil vesting if TSR ranked below median in the peer group; 25% vesting if TSR ranked at the median; 100% vesting if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile.
  - If more than one comparator group is used, vesting of the TSR portion of the award will be determined by the average of the vesting outcomes from each comparator group.
  - Award subject to a secondary financial measure as set out on page 93.
- 50% of award based on average annual EPS growth over the three financial years starting with that in which the award is granted, with 25% vesting for threshold performance, 50% vesting for target performance and 100% vesting for stretch performance. Pro-rata vesting for intermediate performance.

The metrics and weightings applicable in 2017 are as follows:

- 50% of award based on TSR relative to the following two comparator groups over the three-year performance period:
  - At least ten other international defence companies selected by the Committee at the time of grant.
  - All companies in the FTSE 100 index.
- 50% of award based on average annual EPS growth over the three financial years starting with that in which the award is granted, with threshold performance requirement as average annual EPS growth of 3%, target performance requirement as average annual EPS growth of 5% and stretch performance requirement as average annual EPS growth of 7%.

Note that awards granted to executive directors from the date of the 2017 AGM would be subject to application of reasonableness discretion in light of other important factors in the business as described earlier.

The Committee can adjust the weighting of the EPS and TSR conditions and, if considered appropriate, the Committee may introduce an alternate performance condition aligned to the Company's strategy.

See notes 4 and 5 on page 106.

Long-Term Incentives – Share Options

Purpose and link to strategy
Drive and reward delivery of sustained long-term EPS and TSR performance and sustained improvement in the Company's share price.

Operation
Share Options have an exercise price set at market value at grant.

For non-US executive directors, awards vest subject to performance and service conditions on the fifth anniversary of grant and will be exercisable between the fifth and tenth anniversary of grant.

US executive directors are not eligible.

Policy maximum opportunity
Award levels applicable to UK executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Share Options) are as follows:

Chief Executive: 300% of salary

Chief Operating Officer: 300% of salary

Group Finance Director: 300% of salary

Note the percentages above could be exceeded if the LTI EV weightings were to be varied (see page 102).

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

Performance metrics used, weighting and time period applicable
For Share Option awards made to the executive directors, exercise is subject to the TSR and EPS performance conditions (subject to any adjustment described above) and application of reasonableness discretion as set out above.

Note that for Share Option awards granted to the executive directors prior to the 2017 AGM, exercise is subject to the TSR performance conditions as set out in our policy approved at the 2014 AGM.

See notes 4 and 5 on page 106.

Directors' remuneration policy continued

Executive directors' policy table continued

Long-Term Incentives – Restricted Shares

Purpose and link to strategy
Provide long-term reward through time-vesting awards principally in the Company's US market.

Operation
The shares are subject only to the condition that the participant remains employed by the Group on the vesting date (three years after the award date). These awards are not subject to a performance condition as it is designed to address competitive market practice and retention issues principally in the US. Non-US executive directors are not eligible.

Policy maximum opportunity
Award levels applicable to US executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Restricted Shares) are as follows:

President and Chief Executive Officer of BAE Systems, Inc.: 150% of salary

Performance metrics used, weighting and time period applicable
None.

See notes 4 and 5 on page 106.

Benefits

Purpose and link to strategy
Provide employment benefits which ensure that the overall package is market competitive when these elements are taken into account.

Operation
Benefits include provision of a company car (or cash equivalent), life assurance and ill-health benefit cover which are provided directly or through membership of the Company's pension schemes. The main benefits in the UK include a car allowance (currently £16,000 per annum), private use of a chauffeur-driven car and annual medical screening, plus life assurance and ill-health benefit cover provided through membership of the Company's pension schemes.

Opportunity for UK executive directors to participate in the Share Incentive Plan, a tax approved all-employee plan.

In the US, benefits include a cash allowance for car and parking (currently $20,900 per annum) and private use of a chauffeur-driven car, medical and dental benefits, and insured life and disability benefits.

Additional benefits, such as relocation assistance, may also be provided in certain circumstances if considered reasonable and appropriate by the Committee. Relocation assistance comprises reimbursement for direct items of expenditure, such as legal, estate agency, removals and temporary accommodation.

Directors' and Officers' insurance cover is also provided for all executive directors.

Maximum opportunity
Benefits are set at a level which the Committee considers to be appropriate against comparable roles in companies of similar size in the relevant market.

Benefits are as reported and itemised within the single total figure shown as part of the Annual remuneration report on page 85. The maximum cost of such benefits will reflect the associated market-competitive cost of provision. Relocation assistance is based on actual costs incurred which are linked to the size and value of the property, plus a maximum relocation allowance of £2,500.

Participation limits for the Share Incentive Plan are those set by the UK tax authorities from time-to-time.

Performance metrics used, weighting and time period applicable
None.

Executive directors' policy table continued

Pension

Purpose and link to strategy
Provide competitive post-retirement benefits or cash allowance equivalent.

Operation
The current Chief Executive and Group Finance Director as at 22 February 2017 are members of the BAE Systems Executive Pension Scheme and members of an underlying employee pension plan, which together provide a target benefit for executive directors payable at normal retirement age (62) of 1/30th of final pensionable earnings (FPE) for each year of service up to a maximum of two-thirds of FPE. Member contributions are currently 8% of salary. Further detail is provided on page 90 as part of the Annual remuneration report.

The current Chief Operating Officer as at 22 February 2017 is a member of the defined contribution section of the BAE Systems Executive Pension Scheme (EPS DCRP). In line with our policy, Company contributions are 19% of salary and member contributions are 6% of salary. Where the Annual Allowance (AA) is breached, as is the case with the Chief Operating Officer, he will pay member contributions up to the AA limit and the Company contributions will be paid as a salary supplement.

For any new externally-appointed UK executive directors, or internally appointed UK executive directors who are not members of a BAE Systems defined benefit scheme, membership of the BAE Systems EPS DCRP is offered with contribution requirements set as a percentage of base salary dependent on grading. Individuals may elect to receive some or all of their Company contributions as a cash allowance. For any internally-appointed UK executive directors who are already members of a BAE Systems defined benefit scheme, the Company may offer to maintain their membership in that pension arrangement (with the contribution rates appropriate to that arrangement), or the choice of membership of the BAE Systems EPS DCRP as set out above.

Where UK executive directors' pension entitlement or accrual is restricted to the Lifetime Allowance (LTA) and/or the AA, the Company may offer an unfunded pension promise or salary supplement to offset the impact of these restrictions.

The current President and Chief Executive Officer of BAE Systems, Inc. as at 22 February 2017 participates in a Section 401(k) defined contribution arrangement in which the company matches his contributions up to a maximum of 6% of salary, subject to US regulatory limits.

Any new externally-appointed US executive directors, or internally-appointed US executive directors who are not members of a pension plan, would be offered membership of the US Section 401(k) defined contribution plan. For any internally-appointed US executive directors who are members of the 2006 Plan and Non-Qualified Plan, these plans provide a cash sum at retirement equal to the sum of the annual accruals, currently set at $1,000 from the 2006 Plan and $500 from the Non-Qualified Plan. The Company may offer to maintain membership of the 2006 Plan and Non-Qualified Plan, in addition to membership of the US Section 401(k) defined contribution plan.

Maximum opportunity
The BAE Systems EPS DCRP provides a maximum Company contribution of 19% (in addition to employee contribution of 6%) of base salary.

Under the existing executive defined benefit scheme, a maximum of two-thirds of FPE is accrued at 1/30th for each year of service.

Where UK executive directors' pension entitlement or accrual is restricted to the LTA and/or the AA, the Company may offer an unfunded pension promise or salary supplement to offset the impact of these restrictions.

The US Section 401(k) defined contribution plan provides 100% company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits.

For US executive directors who are members of the 2006 Plan and Non-Qualified Plan, these plans provide a cash sum at retirement equal to the sum of the annual accruals, currently set at $1,000 from the 2006 Plan and $500 from the Non-Qualified Plan.

Directors' remuneration policy
continued

Notes to the executive directors' policy table

Remuneration policy for other employees

1. The Company's approach to annual salary reviews is consistent across the Group, with consideration given to the scope of the role, level of experience, performance and market data for similar roles in other companies.
2. All leaders may participate in an annual bonus scheme with similar metrics to those used for the executive directors. Other employees may participate in performance-based incentive plans which vary by organisational level and with relevant metrics for the particular area of the business.
3. LTI grants may be made to the most senior managers in the business (approximately 400 individuals globally). The nature of the awards depends on the individual's location, roles and responsibilities, in particular:
   – performance conditions and targets for performance share grants made to UK and Rest of World participants are made in line with those applying to executive directors;
   – for US participants below Executive Committee level, performance share grants are normally subject to BAE Systems, Inc. operating cash flow and EPS performance conditions and targets;
   – Performance Shares applicable to participants below executive director level vest on the third anniversary subject to performance conditions and are exercisable (or released in the case of US participants) in equal tranches on the third, fourth and fifth anniversary of grant;
   – Share Options are granted to participants below executive director level; there are no performance conditions attached and they vest and are exercisable after three years; and
   – Restricted Share grants are currently made to the most senior managers in the US businesses reflecting competitive market practice and vest after three years.

Performance measures and targets

4. The Committee selected the performance conditions because these are central to the Company's overall strategy and are the key metrics used by the executive directors to oversee the operation of the business. Any non-financial performance targets are determined by the Committee in consultation with the Corporate Responsibility Committee.
5. The performance conditions and targets are determined annually by the Committee (within the parameters set out above), taking account of the Group's strategic objectives, the internal business plan and budgets, as well as external market expectations and general economic conditions. The Committee is of the view that the performance targets for the annual bonus are commercially sensitive and that it would be detrimental to the interests of the Company to disclose them before the start of the financial year. The targets will be disclosed retrospectively after the end of the relevant financial year.

Minimum Shareholding Requirement (MSR)

6. The Committee has agreed a policy whereby the executive directors are required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and other LTI schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. The Committee has discretion to increase the Initial Value and/or Subsequent Value (see below). Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

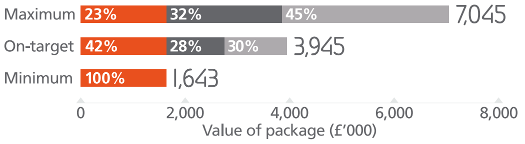
   The following table sets out MSR Initial Value and Subsequent Value applicable from 2018:

	Initial Value	Subsequent Value
Chief Executive	150%	300%
Chief Operating Officer	100%	200%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	212.5%	425%

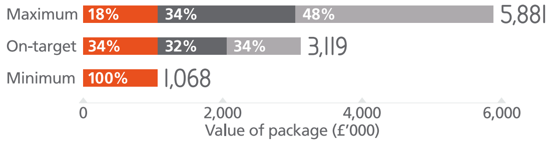
Illustration of application of remuneration policy

The charts below show the value of the package each of the executive directors would receive in the first year of operation of the Policy. The values are based on 2017 levels for base salaries, benefits and pension and assume that the office-holders at the date of this Policy coming into effect are employed throughout the first year of operation of the Policy. Annual and long-term incentives are based on awards applying in 2018. The charts assume the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 85); pay receivable assuming on-target performance is met; and maximum pay assuming variable elements pay out in full. The scenarios below exclude any share price appreciation and dividends.

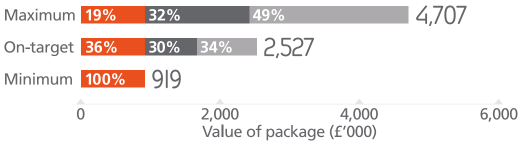
Chief Executive (£'000)



Chief Executive designate (£'000)



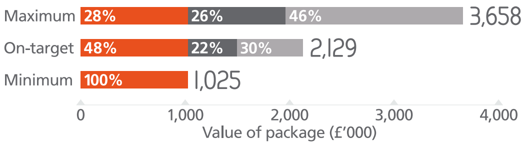
Chief Operating Officer (£'000)



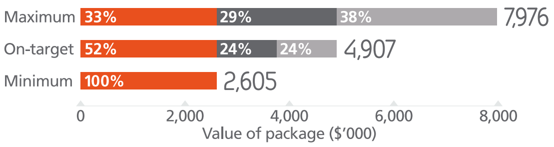
Executive directorship changes

As announced on 22 February 2017, Ian King will retire as Chief Executive on 30 June 2017 and Charles Woodburn, Chief Operating Officer, will be appointed as Chief Executive on 1 July 2017. The left hand chart above illustrates Ian King's remuneration if he were Chief Executive throughout the year, and the right hand chart above illustrates Charles Woodburn's remuneration if he were Chief Executive throughout the year. The chart to the left illustrates Charles Woodburn's remuneration if he were Chief Operating Officer throughout the year.

Group Finance Director (£'000)



President and Chief Executive Officer of BAE Systems, Inc. ($'000)



- Fixed elements of remuneration
- Annual bonus
- Performance Shares and Share Options

Directors' remuneration policy
continued

Non-executive directors' (NEDs) policy table

Fees

Purpose and link to strategy
To attract NEDs who have a broad range of experience and skills to provide independent judgement on issues of strategy, performance, resources and standards of conduct.

Operation
NEDs' fees are set by the Non-Executive Directors' Fees Committee.

NEDs receive a basic fee with an additional fee for those who are chairmen of committees and/or undertake the role of Senior Independent Director.

NEDs also receive a travel allowance per meeting on each occasion that a scheduled Board meeting necessitates air travel of more than five hours (one way) to the meeting location, subject to a maximum of six travel allowances per year.

Fees are typically reviewed annually, taking into account time commitment requirements and responsibility of the individual roles, and after reviewing practice in other comparable companies.

The Chairman's fees are set by the Remuneration Committee on a three-year basis and not normally subject to review during that period.

Maximum opportunity
Actual fee levels are disclosed in the Annual remuneration report for the relevant financial year.

The current Chairman's fee has been set at £700,000 from 1 February 2017 and is fixed at this level for three years.

The aggregate cost of fees and benefits paid to NEDs (including the Chairman) will not exceed an annual limit of £2.5m and the cost of fees and benefits paid to the Chairman will not exceed £1.25m annually.

Performance metrics used, weighting and time period applicable
None.

Benefits

Purpose and link to strategy
Reimbursement for reasonable and documented expenses incurred in the performance of duties.

Operation
NEDs are not eligible to participate in any pension benefits provided by the Company, nor do they participate in any performance-related incentives.

The Chairman is provided with a chauffeur-driven car. This may be used for non-Company business, but the cost of the benefit of such usage shall be paid by the Chairman.

Reimbursement of travel and subsistence costs (including payment of the associated tax cost) incurred by the director or his/her spouse whilst undertaking duties on behalf of the Company that may be assessed as a benefit for tax purposes. Directors' and Officers' insurance cover is also provided for all directors.

Maximum opportunity
See the aggregate limit under 'Fees' above.

Prior commitments
For the duration of this Policy, the Company will honour any commitments made in respect of executive director and non-executive director remuneration and benefits before the date on which either: (i) the Directors' remuneration policy becomes effective; or (ii) an individual becomes a director, even where such commitments are not consistent with the policy set out in this report or prevailing at the time any such commitment is fulfilled. This includes (without limitation) all existing share awards as detailed on page 102 of the 2013 Annual Report under the PSP, SMP, RSP, ExSOP and ExSOP[2012] that remain outstanding, Peter Lynas' second residence allowance as detailed on page 93 of the 2013 Annual Report, and any commitments entered into (such as grants of share awards) consistent with a previously approved Directors' remuneration policy that was applicable at the relevant time.

Approach to recruitment remuneration

The recruitment policy provides an appropriate framework within which to attract individuals of the required calibre to lead a company of BAE Systems' size, scale and complexity. The Remuneration Committee determines the remuneration package for any appointment to an executive director position, either from within or outside BAE Systems.

Operation

The Remuneration Committee will take into consideration all relevant factors, including overall total remuneration, the type of remuneration being offered and the jurisdiction from which the candidate was recruited, and will operate in order to ensure that arrangements are in the best interests of the Company and its shareholders without paying more than is necessary to secure the individual of the required calibre.

The fees and benefits applicable to the appointment of any new non-executive directors will be in accordance with the policy table on page 108.

Opportunity

The Committee seeks to align the remuneration package offered with the policy set out in the executive directors' policy table above recognising that participation under the policy above varies by geography.

- For UK and other non-US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this Policy will not exceed 550% of annual salary.
- For US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this Policy will not exceed 500% of annual salary.

The Committee may make awards on hiring an external candidate to 'buy-out' existing equity or, in exceptional circumstances, other elements of remuneration forfeited on leaving the previous employer. In doing so, the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares) and the time over which they would have vested. Buy-out awards would be capped to be no higher, on recruitment, than the fair value of those forfeited. Full details will be disclosed in the next Annual remuneration report following recruitment which will include details of the need to grant a buy-out award.

Fixed elements (base salary, retirement and other benefits)

The salary level will be set in accordance with the principles for setting base salary described in the executive directors' policy table above.

The executive director shall be eligible to participate in applicable BAE Systems' employee benefit plans, including coverage under applicable executive and employee pension and benefit programmes in accordance with the terms and conditions of such plans, as may be amended by the Company in its sole discretion from time to time.

In the case of promotion of an existing Group employee to an executive directorship on the Board, commitments made before such promotion will continue to be honoured whether or not they are consistent with the remainder of this Policy.

Annual Incentive Plan

The appointed executive director will be eligible to earn a discretionary annual bonus in accordance with the annual incentive framework as described in the executive directors' policy table above.

The level of opportunity will be consistent with the policy disclosed in the executive directors' policy table in this report and subject to the maximums referred to therein and under 'Opportunity' above.

Long-Term Incentive Plan

The executive director will be eligible for equity awards in such amounts as the Committee may determine in its sole discretion, subject to this Policy and the rules of the Long-Term Incentive Plan.

The level of opportunity will be consistent with the policy set out in the executive directors' policy table above and subject to the maximums referred to therein and under 'Opportunity' above.

Other

For internal and external appointments, the Committee may agree that the Company will meet certain relocation expenses in accordance with the provisions described under the Benefits section of the policy table on page 104.

Directors' remuneration policy
continued

Service contracts
Executive directors

Operation
In accordance with long-established policy, all executive directors have rolling service agreements which may be terminated in accordance with the terms of these agreements.

Dates of appointment for executive directors

Name	Date of appointment	Notice period
Ian King	1 September 2008[1]	12 months either party
Charles Woodburn	9 May 2016	12 months either party
Peter Lynas	1 April 2011	12 months either party
Jerry DeMuro	1 February 2014	90 days either party[2]

1. Contract dated 27 June 2008, effective 1 September 2008.
2. Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal.

Notice period
The Committee's policy is that the service contracts of executive directors will not exceed 12 months. In exceptional circumstances, in relation to newly recruiting an executive director operating in a US environment, the notice period may be extended to a maximum of 24 months and structured such that it reduces to no more than 12 months by no later than the end of the first complete year of service.

Change of control
No executive director has provisions in his service contract that relate to a change of control of the Company.

Chairman
The Chairman's appointment is documented in a letter of appointment and he is required to devote no fewer than two days a week to his duties as Chairman. His appointment as Chairman (which commenced on 1 February 2014) will automatically terminate if he ceases to be a director of the Company. The Chairman's appointment was reviewed by the Nominations Committee prior to the end of his initial three-year term and has been extended until February 2020, unless it is terminated earlier in accordance with the Company's Articles of Association or by the Company or the Chairman giving not less than six months' notice.

Non-executive directors
The non-executive directors do not have service contracts but do have letters of appointment detailing the basis of their appointment. The dates of their original appointment are shown below:

Name	Date of appointment	Expiry of current term
Elizabeth Corley	01.02.2016	31.01.2019
Harriet Green	01.11.2010	31.10.2019
Chris Grigg	01.07.2013	30.06.2019
Paula Rosput Reynolds	01.04.2011	31.03.2020
Nick Rose	08.02.2010	07.02.2019
Ian Tyler	08.05.2013	07.05.2019

The non-executive directors are normally appointed for an initial three-year term that, subject to review, may be extended subsequently for further such terms. Any third term of three years is subject to rigorous review, taking into account the need progressively to refresh the Board. Non-executive directors do not have periods of notice.

In accordance with the UK Corporate Governance Code, all directors are subject to annual election or re-election at the Company's AGM.

Policy on payment for loss of office

Operation
The policy on payment for loss of office provides a clear set of principles that govern the payments that will be made for loss of office, and take account of the need to ensure a smooth transition for leadership roles during times of change. The policy that will apply for a specific executive director's payments for loss of office will be the policy that was in place at the point when the payments for loss of office were agreed for the executive director in question.

Any termination payment made in connection with the departure of an executive director will be subject to approval by the Committee, having regard to the terms of the service contract or other legal obligations and the specific circumstances surrounding the termination, including whether the scenario aligns to an example under the approved leaver criteria, performance, service and health or other circumstances that may be relevant.

In addition to payments described below, the Committee may pay such amounts as are necessary to settle or compromise any claim or by way of damages, where the Committee views it as in the best interests of the Company to do so. In the event of the termination of an executive director's contract, it is the Committee's policy to seek to limit any payment to not more than one year's base salary.

Notice and pay in lieu of notice
Executive directors' contracts allow for termination with contractual notice from either party or termination by way of payment of base salary in lieu of notice, at the Company's discretion. Neither notice nor a payment in lieu of notice will be given in the event of gross misconduct. Any new executive director contracts since 2016 (including the Chief Operating Officer) concerning payment in lieu of notice provisions allow for the Committee to exercise discretion to apply phased payments and mitigation on that executive director securing alternative employment.

Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal. If the employment is (a) terminated by the Company (other than for cause as defined in the contract) or (b) he resigned for a 'Good Reason' (as defined in his contract), he is entitled to a termination payment equal to (i) one year's base salary and (ii) a bonus payable at target level pro-rated for service for the relevant financial year. He will also be entitled to a continuation of medical benefits for 18 months (or a cash payment in lieu).

Other than notice payments, the Company has no obligation to make any termination payments when the Chairman's appointment terminates. Non-executive directors do not have periods of notice and the Company has no obligation to make any termination payments when their appointment terminates, other than to pay fees in accordance with the appointment letters.

Retirement benefits
As governed by the rules of the relevant pension plan. No enhancement for leavers will be made.

Annual Incentive Plan
Where an executive director's employment is terminated after the end of a performance year but before the payment is made, the executive director will remain eligible for an annual incentive award for that performance year subject to an assessment based on performance achieved over the period. No award will be made in the event of gross misconduct.

The Committee may, as set out below, exercise its discretion to allow an annual incentive payment for the year of cessation as part of the termination package for executive directors. Where it does so, the exercise of the discretion and reason why the Committee considered such action appropriate will be disclosed.

Where an executive director leaves during the relevant performance year by reason of death, ill-health, disability, retirement, a transfer of business or redundancy, the Committee may use its discretion to determine that an executive director will remain entitled to receive a bonus (subject to an assessment based on performance over the performance year and pro-rated for time) in respect of the financial year in which the individual ceased employment. One third of the bonus will be subject to compulsory deferral as set out previously, unless the Committee decides otherwise.

The Committee's policy is not to award an annual incentive for any portion of the notice period not served.

The treatment set out above does not apply to the President and Chief Executive Officer of BAE Systems, Inc.

Long-Term Incentive Plans
The treatment of outstanding share awards in the event that an executive director leaves is governed by the relevant share plan rules.

Under the Long-Term Incentive Plan, where an executive director leaves the Group by reason of ill-health, injury, disability, retirement with the agreement of the Company, sale of a business or employing company, redundancy or leaving in such circumstances as the Committee determines (each an 'approved leaver'), unvested awards and options generally continue and vest on the normal vesting date (or, in the case of Performance Shares held by US executive directors, the first normal vesting date or, if later, cessation), unless the Committee determines that the awards should vest on cessation. Any performance conditions will be applied at the time of vesting.

On vesting, the number of shares under award will, unless the Committee decides otherwise, be reduced pro-rata to reflect the period in which the executive director was in employment as a proportion of the relevant vesting period (or in the case of Performance Shares held by US executive directors or Performance Shares granted prior to the 2017 AGM, as a proportion of the initial three-year vesting period).

In the event of death, awards generally vest at the time of death subject to the satisfaction of any performance conditions at that time. Awards are then pro-rated as set out above.

Where an executive director's employment is terminated for any other reason, his unvested awards and options will lapse. Options normally remain exercisable for six months after cessation (or vesting, if later) and 12 months after death.

If the Committee exercises its discretion to treat a director as an approved leaver as permissible under the leaver provisions of the share plan rules, the exercise of the discretion and reason why the Committee considered such action appropriate will be disclosed.

Where an executive director's employment is terminated or an executive director is under notice of termination for any reason at the date of award of any Long-Term Incentive awards, no Long-Term Incentive awards will be made.

Consideration of employment conditions elsewhere in the Company
The Committee does not consult directly with employees as part of the process for reviewing executive pay. When considering salary increases for the executive directors, the Committee considers the general level of salary increase across the Group and in the external market.

Stakeholder considerations
The Committee conducts an annual programme of consultation with major shareholders in order to seek their input to the development of remuneration policy or plans.

Statutory and other information

Company registration
BAE Systems plc is a public company limited by shares registered in England and Wales with the registered number 1470151.

Directors
The current directors who served during the 2016 financial year are listed on pages 68 and 69. Elizabeth Corley and Charles Woodburn were appointed to the Board on 1 February 2016 and 9 May 2016, respectively.

Dividend
An interim dividend of 8.6p per share was paid on 30 November 2016. The directors propose a final dividend of 12.7p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2017 to shareholders on the share register on 21 April 2017. Information on dividend waivers is given on page 165.

Annual General Meeting (AGM)
The Company's AGM will be held on 10 May 2017. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

Certain information in the Strategic report
The following items are set out in the Strategic report on pages 1 to 63:

- disclosures in relation to the use of financial instruments;
- particulars of important events affecting the Group which have occurred since 31 December 2016;
- an indication of likely future developments in the business of the Group;
- an indication of the activities of the Group in the field of research and development;
- actions taken to introduce, maintain or develop arrangements aimed at employees; and
- greenhouse gas emissions.

Office of Fair Trading undertakings
As a consequence of the merger between British Aerospace and the former Marconi Electronic Systems businesses in 1999, the Company gave certain undertakings to the Secretary of State for Trade and Industry (now the Secretary of State for Business, Energy and Industrial Strategy). In February 2007, the Company was released from the majority of these undertakings and the remainder have been superseded and varied by a new set of undertakings. Compliance with the undertakings is monitored by a compliance officer. Further information regarding the undertakings and the contact details of the compliance officer may be obtained through the Company Secretary at the Company's registered office or through the Company's website.

Profit forecast
In its Annual Report 2015, the Group made the following statement, which is regarded as a profit forecast for the purposes of the Financial Conduct Authority's Listing Rule 9.2.18:

"In 2016, the Group's underlying earnings per share are expected to be approximately 5% to 10% higher than the adjusted underlying earnings per share of 36.6p* in 2015.

*Reported underlying earnings per share of 40.2p excluding the previously announced 2.6p per share earnings benefit from an overseas tax provision release and an additional 1.7p per share earnings benefit from a UK tax provision release, and adjusting for a 0.7p per share benefit to an assumed US$1.45 to sterling translation rate."

Underlying earnings per share was 40.3p in 2016.

Employees
The Group is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Group.

Political donations
No political donations were made in 2016.

Issued share capital
As at 31 December 2016, BAE Systems' issued share capital of £86,686,002 comprised 3,467,440,044 ordinary shares of 2.5p each and one Special Share of £1.

Treasury shares
As at 1 January 2016, the number of shares held in treasury totalled 301,808,103 (having a total nominal value of £7,545,203 and representing 8.7% of the Company's called up share capital at 1 January 2016). During 2016, the Company used 10,358,742 treasury shares (having a total nominal value of £258,969 and representing 0.3% of the Company's called up share capital at 31 December 2016) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (6,119,083 shares in aggregate), awards under the Free and Matching elements of the International Share Incentive Plan (371,132 shares in aggregate), awards vested under the Performance Share Plan (459,083 shares), awards vested under the Restricted Share Plan (791,792 shares), and options exercised under the Executive Share Option Plan (2,617,652 shares). The treasury shares utilised in respect of the Share Incentive Plan, the International Share Incentive Plan and the Restricted Share Plan were disposed of by the Company for nil consideration. The 2,617,652 shares disposed of by the Company in respect of the Executive Share Option Plan were disposed of by the Company for an aggregate consideration of £4,919,365. As at 31 December 2016, the number of shares held in treasury totalled 291,449,361 (having a total nominal value of £7,286,234 and representing 8.4% of the Company's called up share capital at 31 December 2016).

The rights to treasury shares are restricted in accordance with the Companies Act and, in particular, the voting and dividend rights attaching to these shares are automatically suspended.

Rights and obligations of ordinary shares

On a show of hands at a general meeting every holder of ordinary shares present in person and entitled to vote shall have one vote, and every proxy entitled to vote shall have one vote (unless the proxy is appointed by more than one member in which case the proxy has one vote for and one vote against if the proxy has been instructed by one or more members to vote for the resolution and by one or more members to vote against the resolution; or if the proxy has been instructed by one or more shareholders to vote either for or against a resolution and by one or more of those shareholders to use his discretion how to vote). On a poll, every member present in person or by proxy and entitled to vote shall have one vote for every ordinary share held. Subject to the relevant statutory provisions and the Company's Articles of Association, holders of ordinary shares are entitled to a dividend where declared or paid out of profits available for such purposes. Subject to the relevant statutory provisions and the Company's Articles of Association, on a return of capital on a winding-up, holders of ordinary shares are entitled, after repayment of the £1 Special Share, to participate in such a return. There are no redemption rights in relation to the ordinary shares.

Rights and obligations of the Special Share

The Special Share is held on behalf of the Secretary of State for Business, Energy and Industrial Strategy (the 'Special Shareholder'). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British.

The holder of the Special Share is entitled to attend a general meeting, but the Special Share carries no right to vote or any other rights at any such meeting, other than to speak in relation to any business in respect of the Special Share. Subject to the relevant statutory provisions and the Company's Articles of Association, on a return of capital on a winding-up, the holder of the Special Share shall be entitled to repayment of the £1 capital paid up on the Special Share in priority to any repayment of capital to any other members.

The holder of the Special Share has the right to require the Company to redeem the Special Share at par or convert the Special Share into one ordinary share at any time.

Restrictions on transfer of securities

The restrictions on the transfer of shares in the Company are as follows:

- the Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee;
- the directors shall not register any allotment or transfer of any shares to a foreign person, or foreign persons acting in concert, who at the time have more than a 15% voting interest in the Company, or who would, following such allotment or transfer, have such an interest;
- the directors shall not register any person as a holder of any shares unless they have received: (i) a declaration stating that upon registration, the share(s) will not be held by foreign persons or that upon registration the share(s) will be held by a foreign person or persons; (ii) such evidence (if any) as the directors may require of the authority of the signatory of the declaration; and (iii) such evidence or information (if any) as to the matters referred to in the declaration as the directors consider appropriate;
- the directors may, in their absolute discretion, refuse to register any transfer of shares which are not fully paid up (but not so as to prevent dealings in listed shares from taking place);
- the directors may also refuse to register any instrument of transfer of shares unless the instrument of transfer is in respect of only one class of share and it is lodged at the place where the register of members is kept, accompanied by a relevant certificate or such other evidence as the directors may reasonably require to show the right of the transferor to make the transfer;
- the directors may refuse to register an allotment or transfer of shares in favour of more than four persons jointly;
- where a shareholder has failed to provide the Company with certain information relating to their interest in shares, the directors can, in certain circumstances, refuse to register a transfer of such shares;
- certain restrictions may from time to time be imposed by laws and regulations (for example, insider trading laws);
- restrictions may be imposed pursuant to the Listing Rules of the Financial Conduct Authority whereby certain of the Group's employees require the Company's approval to deal in shares; and
- awards of shares made under the Company's Long-Term Incentive Plan 2014, Deferred Bonus Plan, Performance Share Plan, Restricted Share Plan, Share Incentive Plan, International Share Incentive Plan, Group All-Employee Free Shares Plan and International Profit Sharing Scheme are subject to restrictions on the transfer of shares prior to vesting and/or release.

The Company is not aware of any arrangements between its shareholders that may result in restrictions on the transfer of shares and/or voting rights.

Significant direct and indirect holders of securities

As at 31 December 2016 (and unchanged as at 22 February 2017), the Company had been advised of the following significant direct and indirect interests in the issued ordinary share capital of the Company:

Name of shareholder	Percentage notified
AXA S.A. and its group of companies	5.00%
Barclays PLC	3.98%
BlackRock, Inc.	5.00%
The Capital Group Companies, Inc.	6.05%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	9.97%
Silchester International Investors LLP	3.01%

Exercise of rights of shares in employee share schemes

The trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

Restrictions on voting deadlines

The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

Statutory and other information continued

Appointment and replacement of directors
Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The directors also have the power to make appointments to the Board at any time. Any individual so appointed will hold office until the next AGM and shall then be eligible for re-election.

The majority of directors holding office must be British. Otherwise, the directors who are not British shall vacate office in such order that those who have been in office for the shortest period since their appointment shall vacate their office first, unless all of the directors otherwise agree among themselves. Any director who holds the office of either Chairman (in an executive capacity) or Chief Executive shall also be British.

The Company must have not less than six directors holding office at all times. If the number is reduced to below six, then such number of persons shall be appointed as directors as soon as is reasonably practicable to reinstate the number of directors to six. The Company may by ordinary resolution from time to time vary the minimum number of directors.

At each AGM of the Company, any director who was elected or last re-elected at or before the AGM held in the third calendar year before the then current calendar year must retire by rotation and such further directors must retire by rotation so that in total one-third of the directors retire by rotation each year. A retiring director is eligible for re-election. It is the Board's intention that all directors will stand for election or re-election in 2017 in compliance with the UK Corporate Governance Code.

Amendment of the Company's Articles of Association
The Company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders. Where class rights are varied, such amendments must be approved by the members of each class of shares separately.

In addition, certain provisions of the Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British.

Powers of the directors
The directors are responsible for the management of the business of the Company and may exercise all powers of the Company subject to applicable legislation and regulation, and the Articles of Association.

At the 2016 AGM, the directors were given the power to buy back a maximum number of 316,716,098 ordinary shares at a minimum price of 2.5p each. The maximum price was the higher of (i) an amount equal to 105% of the average of the middle market quotations of the Company's ordinary shares as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the day on which such ordinary shares are contracted to be purchased, and (ii) the higher of the price of the last independent trade and the highest current independent bid on the London Stock Exchange as stipulated in Article 5(1) of the Buy-back and Stabilisation Regulation or, from 3 July 2016, Commission-adopted Regulatory Technical Standards pursuant to article 5(6) of the Market Abuse Regulation.

This power will expire at the earlier of the conclusion of the 2017 AGM or 30 June 2017. A special resolution will be proposed at the 2017 AGM to renew the Company's authority to acquire its own shares.

At the 2016 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,390,369. This power will expire on the earlier of the conclusion of the 2017 AGM or 30 June 2017. Accordingly, a resolution will be proposed at the 2017 AGM to renew the Company's authority to issue further new shares. At the 2016 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £26,390,369 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2017 AGM or 30 June 2017, and a resolution will be proposed at the 2017 AGM to renew this additional authority.

Conflicts of interest
As permitted under the Companies Act 2006, the Company's Articles of Association contain provisions which enable the Board to authorise conflicts or potential conflicts that individual directors may have.

To avoid potential conflicts of interest the Board requires the Nominations Committee to check that any individuals it nominates for appointment to the Board are free of potential conflicts. In addition, the Board's procedures and the induction programme for new directors emphasise a director's personal responsibility for complying with the duties relating to conflicts of interest. The procedure adopted by the Board for the authorisation of conflicts reminds directors of the need to consider their duties as directors and not grant an authorisation unless they believe, in good faith, that this would be likely to promote the success of the Company. As required by law, the potentially conflicted director cannot vote on an authorisation resolution or be counted in the quorum. Any authorisation granted may be terminated at any time and the director is informed of the obligation to inform the Company without delay should there be any material change in the nature of the conflict or potential conflict so authorised.

Directors' indemnities
The Company has entered into deeds of indemnity with all its current directors and those persons who were directors for any part of 2016 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' report.

Change of control – significant agreements
The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

- The Group has entered into a £2bn Revolving Credit Facility dated 12 December 2013 which provides that, in the event of a change of control of the Company, the lenders are entitled to renegotiate terms, or if no agreement is reached on negotiated terms within a certain period, to call for the repayment or cancellation of the facility. The Revolving Credit Facility was undrawn as at 31 December 2016.

- The Company has entered into a Restated and Amended Shareholders Agreement with European Aeronautic Defence and Space Company EADS N.V. (EADS) and Finmeccanica S.p.A. (Finmeccanica) relating to MBDA S.A.S. dated 18 December 2001 (as amended). In the event that control of the Company passes to certain specified third-party acquirors, the agreement allows EADS and Finmeccanica to exercise an option to terminate certain executive management level nomination and voting rights, and certain shareholder information rights of the Company in relation to the MBDA joint venture. Following the exercise of this option, the Company would have the right to require the other shareholders to purchase its interest in MBDA at fair market value.

  The Company and EADS have agreed that if Finmeccanica acquires a controlling interest in the Company, EADS will increase its shareholding in MBDA to 50% by purchasing the appropriate number of shares in MBDA at fair market value.
- The Company, BAE Systems, Inc., BAE Systems (Holdings) Limited and BAE Systems Holdings Inc. entered into a Special Security Agreement dated 23 October 2015 with the US Department of Defense regarding the management of BAE Systems, Inc. in order to comply with the US government's national security requirements. In the event of a change of control of the Company, the Agreement may be terminated or altered by the US Department of Defense.
- In July 2009, BVT Surface Fleet Limited (now BAE Systems Surface Ships Limited) and the UK Ministry of Defence (MoD) entered into a definitive Terms of Business Agreement (ToBA) which sets out a 15-year partnering arrangement, including lead roles for the BVT business on defined surface shipbuilding and support programmes. Where the MoD considers that a proposed change of control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. In the event that there is a change of control of BAE Systems Surface Ships Limited notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the ToBA immediately without compensation or termination charges.

  On 30 September 2014, BAE Systems Surface Ships Limited and the MoD entered into an agreement which sets out terms for the progressive suspension, amendment and termination of the ToBA through the entering into of other contracts, such as the Maritime Support Delivery Framework (MSDF) agreement (see below) which triggered the deletion of elements of the ToBA relating to surface ship support. The current scope of the ToBA has, therefore, been reduced to focus on surface shipbuilding and the MoD retains its right to terminate the ToBA if there is a change of control notwithstanding the objection of the MoD.
- The MSDF agreement between BAE Systems Surface Ships Limited and the MoD became effective on 1 October 2014 and establishes a framework until March 2019 for the provision of surface ship support work and services relating to HM Naval Base Portsmouth. Where the MoD considers that a proposed change of control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. If there is a change of control without notice or notwithstanding the objection of the MoD, the MoD shall be entitled to terminate the MSDF.
- In August 2008, BAE Systems Land Systems (Munitions & Ordnance) Limited (now BAE Systems Global Combat Systems Munitions Limited) and the MoD entered into a 15-year partnering agreement for the provision of ammunition to UK Forces (the Munitions Acquisition Supply Solution (MASS) partnering agreement). Where the MoD considers that a proposed change of control of BAE Systems Global Combat Systems Munitions Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. In the event that there is a change of control of BAE Systems Global Combat Systems Munitions Limited, notwithstanding the objection of the MoD on such grounds, the MoD may, having followed the dispute resolution process, terminate the MASS agreement for default.
- In November 2012, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 4 of the Astute Class programme. In November 2015, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 5 of the Astute Class programme. Where the MoD considers that a proposed change of control of BAE Systems Marine Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement is established with the MoD. In the event that there is a change of control of BAE Systems Marine Limited, notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the agreements immediately.
- In December 2011, BAE Systems Marine Limited entered into a contract with the MoD for the design of the Dreadnought submarines. Where the MoD considers that a change of control of BAE Systems Marine Limited would be contrary to the defence, national interest or national security of the UK, then the change of control shall not take place until agreement is reached with the MoD on how to proceed. In the event that there is a change of control notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the contract with immediate effect.
- In September 2016, BAE Systems Marine Limited entered into a contract with the MoD for the first phase of manufacture of Boat 1 of the Dreadnought Class programme. The MoD is entitled to terminate the contract in the event of a change of control of BAE Systems Marine Limited, provided that the MoD must act reasonably in exercising this right.

In addition, the Company's share plans contain provisions as a result of which options and awards may vest and become exercisable on a change of control of the Company in accordance with the rules of the plans.

Auditors

KPMG LLP have indicated their willingness to be re-appointed as the auditors for the Company and a resolution proposing their re-appointment will be put to the 2017 AGM. As detailed in the Audit Committee report on page 72, an audit re-tender is currently in progress (in which the current incumbent is not competing) with the intention of proposing the appointment of new auditors at the 2018 AGM.

Statutory and other information continued

Statement of directors' responsibilities in respect of the Annual Report and financial statements

The directors are responsible for preparing the Annual Report, and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law, and have elected to prepare the parent company financial statements in accordance with UK accounting standards and applicable law (UK Generally Accepted Accounting Practice), including Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company, and of their profit or loss for that period. In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions, and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group, and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a strategic report, directors' report, directors' remuneration report and corporate governance statement that comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Statement of disclosure of information to auditors

The directors who held office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he/she ought to have taken to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

On behalf of the Board

David Parkes
Company Secretary
22 February 2017

Responsibility statement of the directors in respect of the Annual Report and financial statements

Each of the directors listed below confirms that to the best of their knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company, and the undertakings included in the consolidation taken as a whole; and
- the Strategic report and Directors' report, taken together, include a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

In addition, each of the directors considers that the Annual Report, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the Company's position and performance, business model and strategy.

Sir Roger Carr	Chairman
Ian King	Chief Executive
Jerry DeMuro	President and Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Charles Woodburn	Chief Operating Officer
Elizabeth Corley	Non-executive director
Harriet Green	Non-executive director
Chris Grigg	Non-executive director
Paula Rosput Reynolds	Non-executive director
Nick Rose	Non-executive director
Ian Tyler	Non-executive director

On behalf of the Board

Sir Roger Carr
Chairman
22 February 2017

Independent Auditor's report

to the members of BAE Systems plc only

Opinions and conclusions arising from our audit

1. Our opinion on the financial statements is unmodified

We have audited the financial statements of BAE Systems for the year ended 31 December 2016 set out on pages 122 to 186.

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2016 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with UK accounting standards, including FRS 101, Reduced Disclosure Framework; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

2. Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements, the risks of material misstatement that had the greatest effect on our audit, in decreasing order of audit significance, were as follows:

Recognition of revenues and profits on long-term contracts

Refer to page 73 (Audit Committee report) and pages 128 to 131 (accounting policy and financial disclosures)

Revenue on long-term contracts: £11,659m (2015 £11,139m)

Risk versus 2015: ◀ ▶

Audit risk

A significant proportion of the Group's revenues and profits are derived from long-term contracts.

These contracts include complex technical and commercial requirements and often specify performance milestones to be achieved throughout the contract period, which can last many years. At each balance sheet date, estimates and assumptions involving a high degree of judgement and estimation uncertainty are required in order to:

- assess the proportion of revenues to recognise in line with milestones achieved and contract completion;
- forecast the outturn, and cumulative to date, profit margin on each contract, incorporating appropriate allowances for technical and commercial risks related to performance milestones yet to be achieved, particularly in the case of fixed-price contracts; and
- appropriately identify, value and provide for loss-making contracts.

The directors have a detailed framework, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial aspects of long-term contracts. The LCM framework includes the regular preparation of a Contract Status Report (CSR), which includes key financial and forecast information for the relevant contract.

The risk of material misstatement is that the accounting for the Group's significant contracts does not accurately reflect the progress made and status of the relevant contract at the reporting date.

The contracts requiring the highest degree of judgement that occupied a significant proportion of the audit effort included:

- Astute Class submarines;
- Queen Elizabeth Class aircraft carriers;
- Saudi British Defence Co-operation Programme;
- Typhoon aircraft contracts (European, Saudi and Omani);
- JP 2008; and
- US commercial shipbuilding contracts.

Procedures to address these audit risks included those listed below

We critically assessed the adequacy of the design and tested the effective operation of key controls within the LCM framework and supporting contract-related balances, including:

- transactional controls that underpin the production of long-term contract-related balances, including cost information on contracts, such as the purchase-to-pay cycle and payroll controls;
- programme-level controls, such as periodic peer reviews performed by experienced individuals independent to the contract to challenge assumptions made and judgements taken at pre-determined stages of the contract lifecycle; and
- higher-level controls, such as monthly contract review meetings and quarterly business unit review meetings.

For significant contracts (including those listed in our audit risk description), determined on the basis of the current and future technical or commercial complexity, financial significance and any forecast to be in significant loss-making positions, we also:

- obtained an understanding of the performance and status of the contract through discussion with contract project teams, Group and business unit directors, as well as through attendance at project teams' contract review meetings;
- challenged the Group's positions through the examination of externally available evidence, such as customer correspondence and, in the case of one significant programme, met the customer directly to further corroborate the status of contracts and recoverability of debtors;
- assessed the consistency of information presented in the year-end CSRs with the underlying ledgers, as well as other financial information received and knowledge gained through the above procedures; and
- used our cumulative knowledge of contract issues to challenge the appropriateness of the contract positions reflected in the financial statements at the year end. This included testing that revenue was recognised in the correct period around the year-end date, the assessment of profit margin traded on contracts based on milestones achieved and allowances made for risks, as well as any central overlays to positions reported by subsidiaries.

Independent Auditor's report continued

Net retirement benefit obligations

Refer to page 73 (Audit Committee report) and pages 155 to 163 (accounting policy and financial disclosures)

Group's share of net IAS 19 deficit: £6,054m (2015 £4,501m)

Risk versus 2015: ▼

Audit risk

The Group's share of the pension schemes' net deficit was £6,054m (2015 £4,501m) after allocating £516m (2015 £1,053m) to equity accounted investments.

The determination of the pension scheme liabilities is dependent on market conditions and the setting of key assumptions, such as discount rate, inflation forecasts and life expectancy.

There is a considerable amount of judgement required in setting these assumptions and, given the size of the schemes, small changes in assumptions and estimates used can have a significant impact on the Group's share of the retirement benefit obligations.

Further assumptions are made in the determination of the Group's share of assets and liabilities of the multi-employer schemes in which it participates, principally in relation to changes in the methodology in allocation of the share to MBDA. As of 1 April 2016, the BAE Systems Pension Scheme, the largest scheme for which BAE Systems is a participating employer, representing 54% of the total retirement benefit obligation as at 31 December 2015, underwent a legal separation which removed Airbus as a participating employer. Consequently, the risk associated with the allocation of the multi-employer schemes has reduced.

Procedures to address these audit risks included those listed below

In respect of the valuation of the obligations: We assessed the independence and competence of the Group's external actuaries. With the assistance of our own actuarial specialists, we assessed the key assumptions used in the Group's retirement benefit obligations valuation, including the discount rate, inflation and life expectancy assumptions against externally-derived data. In order to assess the reasonableness of these assumptions, we performed a benchmarking exercise against comparator companies' assumptions.

In respect of the multi-employer allocations: We considered whether the methodology used to allocate a proportion of the Group's retirement benefit obligations to the other participating employers was appropriate. We examined agreements between the Group and the other participating employers to assess the allocation.

In respect of the disclosures: We considered the adequacy of the Group's disclosures in respect of the key assumptions, including the sensitivity of the deficit to changes in these assumptions.

Valuation of goodwill

Refer to page 73 (Audit Committee report) and pages 139 to 141 (accounting policy and financial disclosures)

Goodwill: £10,902m (2015 £9,840m)

Risk versus 2015: ◀ ▶

Audit risk

The Group holds a significant amount of goodwill relating to UK and overseas (principally US) acquisitions from the past 15 years. The estimated recoverable amounts are subjective due to the inherent uncertainty involved in forecasting and discounting future cash flows and in estimating recoverable amounts of fair value less costs to sell.

The uncertainty over future US defence spending as a whole has reduced slightly in the last year, where we have seen the forecast increase in the defence bill. However, the allocation of the budget between BAE Systems and competitors remains uncertain. This places continued importance on the US business to secure export contracts. Both of these factors contribute to the risk that the goodwill allocated to the Group's US Cash-Generating Units (CGUs) will not be recoverable, although we consider this risk to have reduced.

Most of the remaining goodwill is allocated to CGUs based in the UK. Whilst there is still inherent risk in forecasting future cash flows for these businesses, many of them contain sizeable order backlogs, much of which is with government customers, giving some certainty to support the forecasts. We consider the valuation risks around those CGUs to be lower.

The Applied Intelligence CGU operates in a highly competitive and more fragmented market where significant investment is required for growth and where future business pipeline is much shorter than in most other business units in the Group. As such, we consider the uncertainty in forecasting cash flows higher and the valuation of this CGU to have a higher risk.

The Group's annual goodwill impairment testing is based on the five-year Integrated Business Plan (IBP) forecasts. We focus audit effort and procedures on how the directors exercised judgement in the preparation of the IBP due to the inherent uncertainty involved in forecasting cash flows and determining discount rates, which are the basis of the assessment of goodwill recoverability.

The Group's 2016 testing did not identify any impairment charges (2015 £75m impairment charge against the US Intelligence & Security CGU).

Given the uncertainty associated with the valuation of the recoverable amounts, transparent disclosures and clarity of sensitivities to key assumptions are critical to help inform readers how the directors have made their assessment.

Procedures to address these audit risks included those listed below

In respect of the assessment of CGUs: We challenged the directors' assessment of CGUs with reference to the requirements of accounting standards and considered the operating and management structure changes, during the year, in our understanding of the business. We also critically assessed whether the allocation of goodwill to those CGUs was done on a consistent and reasonable basis.

In respect of cash flows: We considered the Group's procedures used to develop the forecasts and the principles and integrity of the Group's discounted cash flow model compared to the requirements within IAS 36, Impairment of Assets. To challenge the reasonableness of those cash flows, we: assessed the historical accuracy of the Group's forecasting, in particular the ability to reliably forecast cash flows in the fifth year of the model (which underpins the terminal value); and considered the forecasts with reference to publicly available information, such as projections of future defence expenditure.

In respect of the discount rate: We compared the Group's assumptions to externally-derived data (for example, bond yields and inflation statistics) where appropriate. We conducted our own assessments to challenge other key inputs, such as projected economic growth, gearing and CGU-specific factors that contribute to forecasting risk. Our own valuation specialists assisted us in assessing the overall discount rate used.

In respect of CGU recoverable amounts: In one instance, we compared the recoverable amount of a CGU with transaction multiples available for similar companies.

As an additional sense check to challenge the recoverable value of goodwill as a whole, we compared the sum of discounted cash flows with the Group's market capitalisation.

In respect of sensitivity of the goodwill valuation to the key assumptions: We have run scenario-specific models including changes to the discount rate and forecast cash flows as well as break-even analyses to stress-test the valuations of CGUs' recoverable amounts.

In respect of the disclosures: We assessed whether the Group's disclosures about the sensitivities to changes in key assumptions reflected the risks inherent in the valuation of goodwill as well as our knowledge of the business.

Tax accruals

Refer to page 74 (Audit Committee report) and pages 123 and 135 to 137 (accounting policy and financial disclosures)

Tax accruals: £365m (2015 £353m)

Risk versus 2015: ◀ ▶

Audit risk

Accruals for tax contingencies require the directors to make judgements and estimates in relation to tax risks. This is one of the key judgement areas that our audit is concentrated on due to the Group operating in a number of tax jurisdictions, the complexities of local and international tax legislation, and the number of years which some matters can take to resolve.

The tax matters are at various stages, from the first identification of risks to discussions with tax authorities and through to tax tribunal or court proceedings. The risk to the financial statements is that the eventual resolution of a matter with tax authorities is at an amount materially different from the estimated accrual.

Procedures to address these audit risks included those listed below

Together with our own UK and international tax specialists, we assessed all large or unusual items affecting the effective tax rate and challenged whether or not any current year items would indicate a requirement for further accruals.

In considering the judgements to recognise tax accruals, our own international and local tax specialists assisted us in assessing the Group's tax positions and the likelihood of future cash outflows. This included the assessment of its correspondence with the relevant tax authorities and government bodies, the Group's external tax advisers and third parties. We also used our knowledge and experience of the application of the international and local legislation by the relevant authorities and courts in order to challenge the positions taken by the directors. In support of these discussions, we separately met with certain external tax advisers of the Group.

We analysed and challenged the assumptions used to estimate the tax accruals and tested the accuracy of calculations.

We have also considered the adequacy of the Group's tax disclosures, including the requirements for disclosure of any contingent liabilities.

Deferred tax assets on UK retirement benefit obligation

Refer to page 74 (Audit Committee report) and pages 123 and 150 to 152 (accounting policy and financial disclosures)

Deferred tax asset: £1,212m (2015 £908m)

Risk versus 2015: New risk

Audit risk

The directors are required to estimate the value of deferred tax assets and to record those assets to the extent their recovery is probable. This requires a significant element of judgement.

The majority of the deferred tax asset balance is in relation to the Group's retirement benefit obligations. As a result of the increase in the valuation of the Group's share of the net retirement benefit obligations, the Group's related deferred tax asset has also increased. Compared with last year, the period required for the Group to recover the full amount of deferred tax has consequently increased, and more judgement is required to estimate how much of this balance is recoverable. For this reason, we have determined that the audit risk has increased.

The risk to the financial statements is that the amount of deferred tax assets recognised is materially different from the amount that will be recovered.

Procedures to address these audit risks included those listed below

We assessed and challenged the directors on their judgement, in particular as to why it is deemed probable that the deferred tax assets recognised will be recovered, including the following considerations:

- the appropriateness and reliability of forecasts used by the directors to estimate the recovery period;
- the consistency of this judgement with other assumptions and estimates made by the directors used to test impairment of assets, including goodwill; and
- the timeframe of the pension deficit recovery plan.

In particular, we considered the current and recent taxation position of the Group's UK entities (the largest element of the pension deficit funding falls in the UK) and the trading prospects of those entities represented in forecasts, secured orders and other secured programmes.

3. Our application of materiality and an overview of the scope of our audit

The materiality for the Group financial statements as a whole was set at £55m (2015 £55m), determined with reference to a benchmark of Group profit before taxation from continuing operations (normalised to remove the effects of goodwill impairments), of which it represents 4.8% (2015 4.7%).

We reported to the Audit Committee any corrected or uncorrected identified misstatements exceeding £2.75m (2015 £2.75m) and those relating wholly to balance sheet classification exceeding £13.75m (2015 £32m) in addition to other identified misstatements that warranted reporting on qualitative grounds.

Eleven (2015 11) of the Group's 41 (2015 41) reporting components were audited for Group reporting purposes and a further 14 (2015 11) were subject to specified risk-focused procedures. The latter were not individually financially significant enough to require an audit for Group reporting purposes, but did present specific individual risks that needed to be addressed.

Independent Auditor's report
continued

The components within the scope of our work accounted for the following percentages of the Group's results:

	Number of components	Group revenue %	Group profit before taxation %	Group total assets %
Audits for Group reporting purposes[1]	11	69	80	84
Specified risk-focused audit procedures[2]	14	25	13	10
Total	**25**	**94**	**93**	**94**
(2015 total)	22	92	89	93

1. In the UK, US, Saudi Arabia and Australia.
2. In the UK, US and Saudi Arabia.

For the remaining components, we performed analysis at an aggregated level to re-examine our assessment that there were no significant risks of material misstatements within these.

The Group audit team instructed component auditors as to the significant areas to be covered, including the relevant risks detailed above and the information to be reported back. The Group audit team approved the component materiality levels, which ranged from £4m to £37m (2015 £3m to £33m), having regard to the mix of size and risk profile of the Group across the components. The work on 20 of the 25 (2015 20 of the 22) in-scope components was performed by component auditors and the remainder by the Group audit team.

The Group audit team hosted planning meetings in the spring and autumn attended by the most significant component teams from the UK, US and Saudi Arabia. In addition, the Group audit team visited component teams in the UK, US, Sweden, Saudi Arabia and Australia to assess the audit risk and strategy, discuss and calibrate the results of controls testing, and discuss preliminary findings of audit procedures. Video and telephone conference meetings were also held with these component auditors and any others that were not physically visited. At these visits and meetings, the findings reported to the Group audit team were discussed in more detail, and any further work required by the Group audit team was then performed by the component auditor.

4. Our opinion on other matters prescribed by the Companies Act 2006 is unmodified
In our opinion:

- the part of the Annual remuneration report required to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic report and the Directors' report for the financial year is consistent with the financial statements.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic report and the Directors' report:

- we have not identified material misstatements in those reports; and
- in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

5. We have nothing to report on the disclosures of principal risks
Based on the knowledge we acquired during our audit, we have nothing material to add or draw attention to in relation to:

- the directors' risk management, internal control and viability assessment on page 71 concerning the principal risks, their management and, based on that, the directors' assessment and expectations of the Group continuing in operation over the five years to 2021; or
- the disclosures in the preparation section of the financial statements concerning the use of the going concern basis of accounting.

6. We have nothing to report in respect of the matters on which we are required to report by exception
Under International Standards of Auditing (UK and Ireland), we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the Annual Report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable, and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; or
- the Audit Committee report does not appropriately address matters communicated by us to the Audit Committee.

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Annual remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statements, set out on page 71, in relation to going concern and longer-term viability; and
- the part of the Director's report section relating to the Company's compliance with the 11 provisions of the 2014 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

Scope and responsibilities

As explained more fully in the directors' responsibilities statement set out on page 116, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2014a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

Ian Starkey
Senior Statutory Auditor

For and on behalf of
KPMG LLP
Statutory Auditor

Chartered Accountants
15 Canada Square
London, E14 5GL
22 February 2017

Financial statements

Group accounts

Company accounts

Group accounting policies
Accounting policies are included within the relevant note to the Group accounts.

Group accounts

Preparation

Basis of preparation
The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis, as discussed in the Directors' report on page 71, and in accordance with EU-endorsed International Financial Reporting Standards (IFRS) and the Companies Act 2006 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date, with the resulting exchange differences recognised in the income statement.

Significant accounting policies
The significant accounting policies applied in the preparation of these consolidated financial statements are set out in the relevant notes. These policies have been applied consistently to all the years presented, unless otherwise stated. The directors believe that the consolidated financial statements reflect appropriate judgements and estimates, and provide a true and fair view of the Group's financial performance and position.

Critical accounting policies
Certain of the Group's significant accounting policies are considered by the directors to be critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements. The critical accounting policies are listed below and explained in more detail in the relevant notes to the Group accounts:

Critical accounting policy	Description	Notes
Revenue and profit recognition		1
– The recognition of revenue and profit on long-term contracts.	The majority of long-term contracts are accounted for under IAS 11, Construction Contracts. Revenue on long-term contracts is recognised when performance milestones have been completed. Profit is recognised progressively as risks have been mitigated or retired. The ultimate profitability of long-term contracts is estimated based on estimates of revenue and costs, including allowances for technical and other risks, which are reliant on the knowledge and experience of the Group's project managers, engineers, and finance and commercial professionals. Material changes in these estimates could affect the profitability of individual contracts. Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances.	
Carrying value of intangible assets		8
– The valuation of acquired intangible assets; and	Acquired intangible assets, excluding goodwill, are valued in line with internationally used models, which require the use of estimates that may differ from actual outcomes. These assets are amortised over their estimated useful lives. Future results are impacted by the amortisation periods adopted and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.	
– the determination of assumptions underpinning goodwill impairment testing.	Goodwill is not amortised, but is tested annually for impairment and carried at cost less accumulated impairment losses. For the purposes of impairment testing, goodwill is allocated to Cash-Generating Units on a consistent basis. The impairment review calculations require the use of estimates of the future profitability and cash-generating ability of the acquired businesses based on the Group's five-year Integrated Business Plan and the pre-tax discount rate used in discounting these projected cash flows.	
Valuation of retirement benefit obligations		20
– The determination of assumptions underpinning the valuation of retirement benefit obligations for defined benefit pension schemes; and	Pension scheme accounting valuations are prepared by independent actuaries. For each of the actuarial assumptions used to measure the Group's pension scheme liabilities, there is a range of possible values and management estimates the point within that range that most appropriately reflects the Group's circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit.	
– the determination of the share of the pension deficit allocated to the Group's equity accounted investments.	The Group operates a number of multi-employer defined benefit pension schemes and allocates a share of the surpluses and deficits in those schemes to the equity accounted investments that participate in them. On 1 April 2016, a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) was created, reducing the total IAS 19, Employee Benefits, deficit, with a corresponding reduction in the allocation to equity accounted investments. The deficit allocation methodology for the remaining employers of the Main Scheme and for all other schemes is based on the relative payroll contributions of active members, which is consistent with prior years. Whilst this methodology is intended to reflect a reasonable estimate of the share of the deficit, it may not accurately reflect the obligations of the participating employers.	

Preparation continued

Other significant accounting policy judgements

In addition to the critical accounting policies, management exercises judgement in applying the Group's accounting policies in respect of the following principal items:

Tax provisions

Management exercises judgement to determine the amount of tax provisions. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The Group's approach is to consider each uncertain tax position separately. Where management considers it is probable (defined as more likely than not) that there will be a future outflow of funds to a tax authority, a provision is recognised. The position is reviewed on an ongoing basis. Provisions are measured using management's best estimate of the most likely amount, being the single most likely amount in a range of possible outcomes. The Group discloses any significant uncertainties in relation to tax matters to the relevant tax authority. The resolution of tax positions taken by the Group can take a considerable period of time to conclude and, in some cases, it is difficult to predict the outcome. The directors believe that adequate provision is made for each known tax risk.

Included within the Consolidated balance sheet as at 31 December 2016 are current tax liabilities of £311m (2015 £315m), which comprise a provision of £365m (2015 £353m) and other tax creditors of £51m (2015 £35m), offset by a debtor of £105m (2015 £73m) in respect of research and development expenditure credits. The provision of £365m (2015 £353m) is in respect of known tax issues, of which £325m (2015 £287m) relates to non-UK jurisdictions. Whilst there is inherent uncertainty regarding the timing of any resolution of tax positions, the Group does not consider that there is a significant risk of material change in 2017.

Deferred tax assets

Included within the net deferred tax asset of £1,241m at 31 December 2016 is £1,212m in respect of the deficits in the Group's pension/retirement schemes (see note 14). It is management's judgement that the Group will generate sufficient taxable profits to recover the net deferred tax asset recognised. This judgement requires the use of estimates of future taxable profits based on the Group's Integrated Business Plan.

Changes in accounting policies

IFRS 9, Financial Instruments, issued in July 2014 with an effective date of 1 January 2018, was EU endorsed in November 2016. It is not expected to have a material impact on the Group.

IFRS 15, Revenue from Contracts with Customers, issued in May 2014 with an effective date of 1 January 2018, was EU endorsed in October 2016. The standard requires the identification of performance obligations in contracts with customers and allocation of the total contractual value to each of the performance obligations identified. Revenue is recognised as each performance obligation is satisfied either at a point in time or over time. The standard will replace IAS 11, Construction Contracts, and IAS 18, Revenue.

An initial impact assessment has been undertaken which involved the review of all contract types across the Group. The assessment indicates that revenue on the Group's long-term contracts currently being recognised based on the completion of separately identifiable phases (milestones) will cumulatively be recognised earlier under IFRS 15, which reflects the continual transfer of the benefits of the Group's performance to the customer. It is expected that profit will continue to be recognised progressively as risks have been mitigated and retired and, accordingly, it is not expected that there will be a material impact on the timing of profit recognition. There is no impact on the timing of cash receipts, which are determined by the terms and conditions of contracts with the customers. The assessment has not indicated any significant changes will be required to the Group's revenue recognition policy in respect of revenue from the sale of goods not under long-term contract, services or licences.

IFRS 16, Leases, issued in January 2016 with an effective date of 1 January 2019, is not yet EU endorsed. Currently, leases classified as operating leases are not recognised on the balance sheet. The impact of this standard will be to recognise a lease liability and corresponding asset on the Group's balance sheet in respect of the majority of leases currently classified as operating leases.

Consolidation

The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' results accounted for under the equity method.

A subsidiary is an entity controlled by the Group. The Group controls a subsidiary when it is exposed, or has the rights, to variable returns from its involvement with the subsidiary and has the ability to affect those returns through its power over the subsidiary.

The results of subsidiaries are included in the income statement from the date of acquisition.

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

Joint ventures are accounted for under the equity method where the Consolidated income statement includes the Group's share of their profits and losses, and the Consolidated balance sheet includes its share of their net assets within equity accounted investments.

The assets and liabilities of overseas subsidiaries and equity accounted investments are translated at the exchange rates ruling at the balance sheet date. The income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity, but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised in equity since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Consolidated income statement
for the year ended 31 December

	Notes	2016 £m	2016 Total £m	2015 £m	2015 Total £m
Continuing operations					
Sales	1	**19,020**		17,904	
Deduct Share of sales by equity accounted investments	1	**(2,427)**		(2,719)	
Add Sales to equity accounted investments	1	**1,197**		1,602	
Revenue	1		**17,790**		16,787
Operating costs	2		**(16,274)**		(15,622)
Other income	4		**136**		227
Group operating profit			**1,652**		1,392
Share of results of equity accounted investments	1		**90**		110
Underlying EBITA	1	**1,905**		1,683	
Non-recurring items	1	**(12)**		26	
EBITA		**1,893**		1,709	
Amortisation of intangible assets	1	**(87)**		(108)	
Impairment of intangible assets	1	**–**		(78)	
Financial (expense)/income of equity accounted investments	5	**(28)**		3	
Taxation expense of equity accounted investments	6	**(36)**		(24)	
Operating profit	1		**1,742**		1,502
Financial income		**713**		241	
Financial expense		**(1,304)**		(653)	
Net finance costs	5		**(591)**		(412)
Profit before taxation			**1,151**		1,090
Taxation expense	6		**(213)**		(147)
Profit for the year			**938**		943
Attributable to:					
Equity shareholders			**913**		918
Non-controlling interests			**25**		25
			938		943
Earnings per share	7				
Basic earnings per share			**28.8p**		29.0p
Diluted earnings per share			**28.7p**		28.9p

Consolidated statement of comprehensive income
for the year ended 31 December

		2016			2015[1]		
	Notes	Other reserves[2] £m	Retained earnings £m	Total £m	Other reserves[2] £m	Retained earnings £m	Total £m
Profit for the year		–	**938**	**938**	–	943	943
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Subsidiaries:							
Remeasurements on retirement benefit schemes		–	**(1,468)**	**(1,468)**	–	864	864
Tax on items that will not be reclassified to the income statement	6	–	**260**	**260**	–	(258)	(258)
Equity accounted investments (net of tax)		–	**(53)**	**(53)**	–	18	18
Items that may be reclassified to the income statement:							
Subsidiaries:							
Currency translation on foreign currency net investments		**1,287**	–	**1,287**	260	–	260
Reclassification of cumulative currency translation reserve on disposal		–	–	–	20	–	20
Fair value loss on available-for-sale financial assets		–	–	–	–	(1)	(1)
Amounts credited to hedging reserve		**96**	–	**96**	11	–	11
Tax on items that may be reclassified to the income statement	6	**(17)**	–	**(17)**	(2)	–	(2)
Equity accounted investments (net of tax)		**45**	–	**45**	(74)	–	(74)
Total other comprehensive income for the year (net of tax)		**1,411**	**(1,261)**	**150**	215	623	838
Total comprehensive income for the year		**1,411**	**(323)**	**1,088**	215	1,566	1,781
Attributable to:							
Equity shareholders		**1,408**	**(348)**	**1,060**	216	1,541	1,757
Non-controlling interests		**3**	**25**	**28**	(1)	25	24
		1,411	**(323)**	**1,088**	215	1,566	1,781

1. Re-presented in accordance with Amendments to IAS 1: Disclosure Initiative.
2. An analysis of other reserves is provided in note 22.

Consolidated statement of changes in equity
for the year ended 31 December

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves[1] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2016	87	1,249	5,277	(3,624)	2,989	13	3,002
Profit for the year	–	–	–	913	913	25	938
Total other comprehensive income for the year	–	–	1,408	(1,261)	147	3	150
Share-based payments (inclusive of tax)	–	–	–	59	59	–	59
Net sale of own shares	–	–	–	3	3	–	3
Ordinary share dividends	–	–	–	(670)	(670)	(24)	(694)
Partial disposal of shareholding in subsidiary undertaking	–	–	–	(3)	(3)	9	6
At 31 December 2016	**87**	**1,249**	**6,685**	**(4,583)**	**3,438**	**26**	**3,464**
At 1 January 2015	87	1,249	5,061	(4,555)	1,842	35	1,877
Profit for the year	–	–	–	918	918	25	943
Total other comprehensive income for the year	–	–	216	623	839	(1)	838
Share-based payments	–	–	–	44	44	–	44
Net sale of own shares	–	–	–	1	1	–	1
Ordinary share dividends	–	–	–	(655)	(655)	(40)	(695)
Disposal of non-controlling interest	–	–	–	–	–	(6)	(6)
At 31 December 2015	87	1,249	5,277	(3,624)	2,989	13	3,002

1. An analysis of other reserves is provided in note 22.

Consolidated balance sheet
as at 31 December

	Notes	2016 £m	2015 £m
Non-current assets			
Intangible assets	8	**11,264**	10,117
Property, plant and equipment	9	**2,098**	1,698
Investment property	10	**110**	120
Equity accounted investments	11	**299**	250
Other investments		**6**	6
Other receivables	12	**351**	275
Retirement benefit surpluses	20	**223**	193
Other financial assets	13	**345**	107
Deferred tax assets	14	**1,251**	985
		15,947	13,751
Current assets			
Inventories	15	**744**	726
Trade and other receivables including amounts due from customers for contract work	12	**3,305**	2,940
Current tax		**5**	4
Other financial assets	13	**204**	105
Cash and cash equivalents	16	**2,769**	2,537
Assets held for sale		**2**	20
		7,029	6,332
Total assets	17	**22,976**	20,083
Non-current liabilities			
Loans	18	**(4,425)**	(3,775)
Other payables	19	**(1,027)**	(1,020)
Retirement benefit obligations	20	**(6,277)**	(4,694)
Other financial liabilities	13	**(102)**	(72)
Deferred tax liabilities	14	**(10)**	(13)
Provisions	21	**(372)**	(354)
		(12,213)	(9,928)
Current liabilities			
Loans and overdrafts	18	**–**	(237)
Trade and other payables	19	**(6,540)**	(6,162)
Other financial liabilities	13	**(212)**	(130)
Current tax		**(311)**	(315)
Provisions	21	**(234)**	(301)
Liabilities held for sale		**(2)**	(8)
		(7,299)	(7,153)
Total liabilities		**(19,512)**	(17,081)
Net assets		**3,464**	3,002
Capital and reserves			
Issued share capital	22	**87**	87
Share premium		**1,249**	1,249
Other reserves	22	**6,685**	5,277
Retained earnings – deficit		**(4,583)**	(3,624)
Total equity attributable to equity holders of the parent		**3,438**	2,989
Non-controlling interests		**26**	13
Total equity		**3,464**	3,002

Approved by the Board on 22 February 2017 and signed on its behalf by:

I G King
Chief Executive

P J Lynas
Group Finance Director

Consolidated cash flow statement
for the year ended 31 December

	Notes	2016 £m	2015[1] £m
Profit for the year		**938**	943
Taxation expense	6	**213**	147
Research and development expenditure credits	4	**(22)**	(65)
Share of results of equity accounted investments	1	**(90)**	(110)
Net finance costs	5	**591**	412
Depreciation, amortisation and impairment	2	**345**	460
Profit on disposal of property, plant and equipment	2,4	**(5)**	(28)
Profit on disposal of investment property	2,4	**(12)**	(41)
Profit on disposal of non-current other investments		**–**	(1)
Loss on disposal of businesses	2	**–**	24
Cost of equity-settled employee share schemes		**55**	44
Movements in provisions		**(122)**	(139)
Decrease in liabilities for retirement benefit obligations		**(214)**	(234)
Decrease/(increase) in working capital:			
Inventories		**95**	(6)
Trade and other receivables		**(93)**	60
Trade and other payables		**(263)**	(542)
Taxation paid		**(187)**	(116)
Net cash flow from operating activities		**1,229**	808
Dividends received from equity accounted investments	11	**38**	41
Net interest paid		**(200)**	(173)
Purchase of property, plant and equipment, and investment property		**(408)**	(359)
Purchase of intangible assets		**(82)**	(54)
Proceeds from sale of property, plant and equipment, and investment property		**45**	136
Proceeds from sale of non-current other investments		**–**	1
Purchase of subsidiary undertakings		**–**	(5)
Equity accounted investment funding	11	**(5)**	(8)
Proceeds from sale of subsidiary undertakings		**6**	34
Cash and cash equivalents disposed of with subsidiary undertakings		**–**	(13)
Net cash flow from investing activities		**(606)**	(400)
Net sale of own shares		**3**	1
Equity dividends paid	22	**(670)**	(655)
Dividends paid to non-controlling interests		**(24)**	(40)
Cash inflow from matured derivative financial instruments		**480**	12
Cash inflow from movement in cash collateral		**32**	3
Cash inflow from loans		**–**	1,625
Cash outflow from repayment of loans		**(286)**	(1,135)
Net cash flow from financing activities		**(465)**	(189)
Net increase in cash and cash equivalents		**158**	219
Cash and cash equivalents at 1 January		**2,537**	2,313
Effect of foreign exchange rate changes on cash and cash equivalents		**76**	5
Cash and cash equivalents at 31 December	16	**2,771**	2,537
Comprising:			
Cash and cash equivalents		**2,769**	2,537
Cash classified as held for sale		**2**	–
Cash and cash equivalents at 31 December	16	**2,771**	2,537

1. Re-presented to reclassify interest paid from operating to investing activities.

Notes to the Group accounts

1. Segmental analysis

Revenue and profit recognition
Revenue represents income derived from the provision of goods and services by the Company and its subsidiary undertakings.

Long-term contracts
The majority of the Group's long-term contract arrangements are accounted for under IAS 11, Construction Contracts. Revenue is recognised when the Group has obtained the right to consideration in exchange for its performance, which is when a separately identifiable phase (milestone) of a contract or development has been completed.

Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. No profit is recognised until the outcome of a contract can be reliably estimated. Profit is recognised progressively as risks have been mitigated or retired.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered
Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

Revenue from the sale of software licences is recognised on delivery to the customer when the Group has no remaining obligations to perform and collection of the consideration is considered probable. In circumstances where the Group has future obligations to perform as part of a software licence and related services contract, revenue is recognised over the contract term.

Revenue and profits on intercompany trading are determined on an arm's-length basis.

Research and development
The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Where the research and development activity is performed on behalf of customers, the revenue arising is recognised in the income statement in accordance with the Group's revenue recognition policy on long-term contracts.

Reporting segments
The Group has six reporting segments, which align with the Group's strategic direction, determined with reference to the products and services they provide, and the markets in which they operate:

- **Electronic Systems** comprises the US and UK-based electronics activities, including electronic warfare systems, electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems;
- **Cyber & Intelligence** comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence business, and covers the Group's cyber security, secure government, and commercial and financial security activities;
- **Platforms & Services (US)** has operations in the US, UK and Sweden. It produces combat vehicles, weapons and munitions, and delivers services and sustainment activities, including ship repair and the management of government-owned munitions facilities;
- **Platforms & Services (UK)** comprises the Group's UK-based air, maritime, land and shared services activities;
- **Platforms & Services (International)** comprises the Group's businesses in Saudi Arabia, Australia and Oman, together with its 37.5% interest in the pan-European MBDA joint venture; and
- **HQ** comprises the Group's head office activities, together with a 49% interest in Air Astana.

The Board (the chief operating decision maker as defined by IFRS 8, Operating Segments) monitors the results of these reporting segments to assess performance and make decisions about the allocation of resources. Segmental performance is evaluated based on Key Performance Indicators – sales (see page 129) and underlying EBITA (see page 130). Finance costs and taxation expense are managed on a Group basis.

1. Segmental analysis continued

Key Performance Indicator – Sales
Definition Revenue including the Group's share of revenue of equity accounted investments.

Purpose Allows management to monitor the sales performance of subsidiaries and equity accounted investments.

Sales and revenue by reporting segment

	Sales		Deduct Share of sales by equity accounted investments		Add Sales to equity accounted investments		Revenue	
	2016 £m	2015[1] £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015[1] £m
Electronic Systems	**3,282**	2,922	**(79)**	(72)	**79**	72	**3,282**	2,922
Cyber & Intelligence	**1,778**	1,564	**–**	–	**–**	–	**1,778**	1,564
Platforms & Services (US)	**2,874**	2,779	**(91)**	(101)	**–**	–	**2,783**	2,678
Platforms & Services (UK)	**7,806**	7,405	**(1,118)**	(1,524)	**1,011**	1,438	**7,699**	7,319
Platforms & Services (International)	**3,943**	3,742	**(906)**	(785)	**–**	–	**3,037**	2,957
HQ	**233**	237	**(233)**	(237)	**–**	–	**–**	–
	19,916	18,649	**(2,427)**	(2,719)	**1,090**	1,510	**18,579**	17,440
Intra-group sales/revenue	**(896)**	(745)	**–**	–	**107**	92	**(789)**	(653)
	19,020	17,904	**(2,427)**	(2,719)	**1,197**	1,602	**17,790**	16,787

	Intra-group revenue		Revenue from external customers	
	2016 £m	2015 £m	**2016 £m**	2015[1] £m
Electronic Systems	**92**	91	**3,190**	2,831
Cyber & Intelligence	**58**	55	**1,720**	1,509
Platforms & Services (US)	**43**	22	**2,740**	2,656
Platforms & Services (UK)	**592**	480	**7,107**	6,839
Platforms & Services (International)	**4**	5	**3,033**	2,952
	789	653	**17,790**	16,787

1. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

Sales and revenue by customer location

	Sales		Revenue	
	2016 £m	2015 £m	**2016 £m**	2015 £m
UK	**4,033**	4,006	**3,869**	3,812
Rest of Europe[1]	**2,174**	2,506	**1,645**	1,971
US	**6,920**	6,380	**6,920**	6,377
Canada	**92**	74	**92**	74
Saudi Arabia	**4,043**	3,839	**3,808**	3,653
Rest of Middle East	**720**	102	**693**	63
Australia	**535**	559	**534**	558
Rest of Asia and Pacific	**369**	347	**167**	234
Africa, and Central and South America	**134**	91	**62**	45
	19,020	17,904	**17,790**	16,787

1. Includes £1.0bn (2015 £1.4bn) generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

Notes to the Group accounts
continued

1. Segmental analysis continued

Revenue by category

	2016 £m	2015[1] £m
Long-term contracts	**11,659**	11,139
Sale of goods	**3,223**	2,974
Provision of services	**2,903**	2,669
Royalty income	**5**	5
	17,790	16,787

1. Restated.

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2016 £m	2015 £m
UK Ministry of Defence[1]	**4,402**	4,838
US Department of Defense	**4,319**	3,838
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**3,726**	3,582

1. Includes £1.0bn (2015 £1.4bn) generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by the five principal reporting segments. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the Platforms & Services (UK) and Platforms & Services (International) reporting segments.

Key Performance Indicator – Underlying EBITA

Definition Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature:

– **Loss on business transactions:** Non-recurring items in 2016 represents an impairment of £12m against the carrying value of the BAE Systems San Francisco Ship Repair business sold in January 2017. A loss on the disposal of the Group's 75% holding in BAE Systems Land Systems South Africa (Pty) Limited of £24m was included in non-recurring items in 2015.

– **Research and development expenditure credits relating to prior years:** In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and reflected the change in the 2015 accounts. Credits relating to 2013 and 2014, totalling £50m, were included in non-recurring items in 2015.

Purpose Provides a measure of operating profitability that is comparable over time.

1. Segmental analysis continued

Operating profit/(loss) by reporting segment

	Underlying EBITA		Non-recurring items		Amortisation and impairment of intangible assets		Financial and taxation (expense)/ income of equity accounted investments		Operating profit/(loss)	
	2016 £m	2015[1] £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015[1] £m
Electronic Systems	**494**	437	**–**	–	**(20)**	(18)	**–**	–	**474**	419
Cyber & Intelligence	**90**	104	**–**	–	**(31)**	(135)	**–**	–	**59**	(31)
Platforms & Services (US)	**211**	177	**(12)**	(24)	**(15)**	(13)	**(2)**	2	**182**	142
Platforms & Services (UK)	**810**	721	**–**	50	**(15)**	(11)	**(15)**	(4)	**780**	756
Platforms & Services (International)	**400**	335	**–**	–	**(6)**	(9)	**(29)**	(27)	**365**	299
HQ	**(100)**	(91)	**–**	–	**–**	–	**(18)**	8	**(118)**	(83)
	1,905	1,683	**(12)**	26	**(87)**	(186)	**(64)**	(21)	**1,742**	1,502
Net finance costs									**(591)**	(412)
Profit before taxation									**1,151**	1,090
Taxation expense									**(213)**	(147)
Profit for the year									**938**	943

1. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

Share of results of equity accounted investments within reporting segments

	Underlying EBITA		Amortisation of intangible assets		Financial (expense)/income		Taxation (expense)/income		Share of results of equity accounted investments	
	2016 £m	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m
Electronic Systems	**5**	7	**–**	–	**–**	–	**–**	–	**5**	7
Platforms & Services (US)	**12**	12	**–**	–	**(2)**	(1)	**–**	3	**10**	14
Platforms & Services (UK)	**15**	15	**–**	–	**(5)**	(2)	**(10)**	(2)	**–**	11
Platforms & Services (International)	**107**	96	**(4)**	(4)	**(6)**	(5)	**(23)**	(22)	**74**	65
HQ	**19**	5	**–**	–	**(15)**	11	**(3)**	(3)	**1**	13
	158	135	**(4)**	(4)	**(28)**	3	**(36)**	(24)	**90**	110

Notes to the Group accounts
continued

2. Operating costs

Leases
Lease payments made under operating leases, including any incentives granted, are recognised in the income statement on a straight-line basis over the lease term.

Research and development
The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on research, and on development activities not meeting the conditions for capitalisation, is written off as incurred and charged to the income statement.

Customer-funded expenditure on research and development activities is held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Group's revenue recognition policy on long-term contracts.

	2016 £m	2015 £m
Raw materials, subcontracts and other bought-in items	**5,742**	6,030
Change in inventories of finished goods and work-in-progress	**1,415**	1,027
Cost of inventories expensed	**7,157**	7,057
Staff costs (note 3)	**5,440**	5,052
Depreciation, amortisation and impairment	**345**	460
Loss on disposal of property, plant and equipment, and investment property	**2**	4
Loss on disposal of businesses	**–**	24
Other operating charges	**3,330**	3,025
Operating costs	**16,274**	15,622
Included within the analysis of operating costs are the following expenses:		
Lease and sublease expense	**284**	257
Research and development expense including amounts funded under contract	**1,416**	1,263

Fees payable to the Company's auditor and its associates included in operating costs

	2016			2015		
	UK £'000	**Overseas £'000**	**Total £'000**	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	**1,776**	**–**	**1,776**	1,759	–	1,759
Fees payable to the Company's auditor and its associates for other services pursuant to legislation:						
The audit of the Company's subsidiaries*	**2,663**	**4,143**[1]	**6,806**	2,612	3,659	6,271
Interim review*	**497**	**–**	**497**	490	–	490
Other	**112**	**3**	**115**	164	19	183
Audit-related assurance services:						
Advice on accounting matters	**–**	**–**	**–**	–	6	6
Tax compliance services	**17**	**576**	**593**	22	457	479
Tax advisory services	**9**	**122**	**131**	30	125	155
Other assurance services:						
Non-statutory financial statements audit	**–**	**7**	**7**	–	1,806[2]	1,806[2]
Other non-audit services:						
Investor relations	**200**	**–**	**200**	220	–	220
Other	**83**	**31**	**114**	184	47	231
Total fees payable to the Company's auditor and its associates	**5,357**	**4,882**	**10,239**	5,481	6,119	11,600
*Total fees payable to the Company's auditor and its associates for audit services and interim review			**9,079**			8,520
Fees in respect of BAE Systems pension schemes:						
Audit	**–**	**278**	**278**	140	241	381
Tax compliance	**–**	**2**	**2**	–	4	4
Tax advisory	**23**	**–**	**23**	19	–	19
	23	**280**	**303**	159	245	404

1. After excluding the impact of foreign exchange translation, the fees for the audit of the Company's subsidiaries have increased by 2%.
2. Previously categorised as M&A services.

3. Employees

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2016 Number '000	2015[1] Number '000	**2016 Number '000**	2015[1] Number '000
Electronic Systems	**14**	13	**14**	14
Cyber & Intelligence	**12**	12	**12**	11
Platforms & Services (US)	**11**	11	**11**	11
Platforms & Services (UK)	**29**	29	**29**	29
Platforms & Services (International)	**9**	10	**9**	9
HQ	**1**	1	**1**	1
	76	76	**76**	75

1. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2016 £m	2015[1] £m
Wages and salaries[2]	**4,672**	4,339
Social security costs	**365**	333
Share-based payments (note 27)	**55**	44
Pension costs – defined contribution plans (note 20)	**163**	140
Pension costs – defined benefit plans (note 20)	**183**	194
US healthcare costs (note 20)	**2**	2
	5,440	5,052

1. Re-presented to include the charge in respect of the equity-settled all-employee Free Shares and Matching Partnership Shares elements of the Share Incentive Plan in share-based payments rather than wages and salaries.
2. After excluding the impact of exchange translation, wages and salaries increased by 2% per employee on 2015.

4. Other income

Leases
Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

	2016 £m	2015 £m
Research and development expenditure credits[1]	**22**	65
Rental income from operating leases – investment property	**24**	23
Rental income from operating leases – other	**18**	19
Profit on disposal of property, plant and equipment	**7**	28
Profit on disposal of investment property	**12**	45
Profit on disposal of non-current other investments	**–**	1
Management recharges to equity accounted investments (note 28)	**16**	17
Royalties	**8**	3
Other[2]	**29**	26
Other income	**136**	227

1. In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and reflected the change in the 2015 accounts. Credits relating to 2013 and 2014, totalling £50m, were included in 2015.
2. There are no individual amounts in excess of £10m.

Notes to the Group accounts
continued

5. Net finance costs

Interest income and borrowing costs
Interest income and borrowing costs are recognised in the income statement in the period in which they are incurred.

	2016 £m	2015 £m
Interest income	10	17
Gain on remeasurement of financial instruments at fair value through profit or loss[1,2]	665	167
Foreign exchange gains	38	57
Financial income	713	241
Interest expense on bonds and other financial instruments	(208)	(175)
Facility fees	(4)	(4)
Net present value adjustments	(43)	(29)
Net interest expense on retirement benefit obligations (note 20)	(169)	(192)
Loss on remeasurement of financial instruments at fair value through profit or loss[1]	(55)	(72)
Foreign exchange losses[3]	(825)	(181)
Financial expense	(1,304)	(653)
Net finance costs	**(591)**	(412)

1. Comprises gains and losses on derivative financial instruments, including derivative instruments to manage the Group's exposure to interest rate fluctuations on external borrowings and exchange rate fluctuations on balances with the Group's subsidiaries and equity accounted investments.
2. The increase in the gain on remeasurement of financial instruments primarily reflects exchange rate movements on hedges relating to US dollar-denominated borrowings (2016 £446m; 2015 £98m). Loss on remeasurement of financial instruments includes £23m (2015 £nil) in respect of these exchange rate movements.
3. The increase in foreign exchange losses primarily reflects exchange rate movements on US dollar-denominated borrowings (2016 £592m; 2015 £144m).

Additional analysis

	2016 £m	2015 £m
Net finance costs:		
Group	(591)	(412)
Share of equity accounted investments	(28)	3
	(619)	(409)
Analysed as:		
Underlying net interest expense:		
Group	(245)	(191)
Share of equity accounted investments	(12)	(3)
	(257)	(194)
Other:		
Group:		
Net interest expense on retirement benefit obligations	(169)	(192)
Fair value and foreign exchange adjustments on financial instruments and investments[1]	(177)	(29)
Share of equity accounted investments:		
Net interest expense on retirement benefit obligations	(8)	(8)
Fair value and foreign exchange adjustments on financial instruments and investments	(8)	14
	(619)	(409)

1. The net cost primarily reflects foreign exchange translational losses on US dollar-denominated bonds held by BAE Systems plc.

6. Taxation expense

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

Current tax
Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax
Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

- on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;
- related to investments in subsidiaries and equity accounted investments to the extent that it is probable that they will not reverse in the foreseeable future; and
- arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Taxation expense

	2016 £m	2015 £m
Current taxation		
UK:		
Current tax	**(74)**	(109)
Adjustments in respect of prior years[1]	**29**	17
	(45)	(92)
Overseas:		
Current year	**(164)**	(105)
Adjustments in respect of prior years[2]	**(5)**	99
	(169)	(6)
	(214)	(98)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	**14**	8
Adjustments in respect of prior years	**4**	8
Tax rate adjustment	**–**	(5)
	18	11
Overseas:		
Origination and reversal of temporary differences	**(28)**	(51)
Adjustments in respect of prior years	**13**	(9)
Tax rate adjustment	**(2)**	–
	(17)	(60)
	1	(49)
Taxation expense	**(213)**	(147)
UK	**(27)**	(81)
Overseas	**(186)**	(66)
Taxation expense	**(213)**	(147)

1. 2015 included a £52m credit in respect of the adjustment of certain UK tax provisions in the light of clarification received.
2. 2015 included an £82m credit in respect of the adjustment of certain overseas tax provisions in the light of rulings received.

Notes to the Group accounts
continued

6. Taxation expense continued

Reconciliation of taxation expense

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2016 £m	2015 £m
Profit before taxation	**1,151**	1,090
UK corporation tax rate	**20.0%**	20.25%
Expected income tax expense	**(230)**	(221)
Effect of tax rates in foreign jurisdictions, including US state taxes	**(81)**	(69)
Effect of intra-group financing	**15**	13
Expenses not tax effected	**(15)**	(13)
Income not subject to tax	**37**	41
Research and development tax credits and patent box benefits	**12**	7
Non-deductible goodwill impairment	**–**	(15)
Chargeable gains and non-taxable gains/non-deductible losses on disposal of businesses	**(3)**	(7)
Utilisation of previously unrecognised tax losses	**3**	4
Adjustments in respect of prior years[1]	**41**	115
Adjustments in respect of equity accounted investments	**18**	22
Tax rate adjustment	**(2)**	(5)
Other	**(8)**	(19)
Taxation expense	**(213)**	(147)

Calculation of the underlying effective tax rate

	2016 £m	2015 £m
Profit before taxation	**1,151**	1,090
Add back:		
Taxation expense of equity accounted investments (note 1)	**36**	24
Loss on disposal of businesses (note 1)	**–**	24
Goodwill impairment (note 8)	**–**	75
Adjusted profit before taxation	**1,187**	1,213
Taxation expense	**(213)**	(147)
Taxation expense of equity accounted investments (note 1)	**(36)**	(24)
Taxation expense (including equity accounted investments)	**(249)**	(171)
Adjusted profit before taxation (above)		1,213
Exclude: Research and development expenditure credits[2]		(77)
		1,136
Taxation expense (including equity accounted investments) (above)		(171)
Exclude: Adjustments relating to research and development expenditure credits[2]		68
Exclude: Adjustment of tax provisions[1]		(134)
		(237)
Underlying effective tax rate	**21%**	21%

1. 2016 comprises a number of separate items, individually less than £20m, in relation to which either resolution was reached in the year or new information enabled the Group to re-assess the related tax provisions. 2015 included credits totalling £134m in respect of the adjustment of certain UK and overseas tax provisions in the light of clarification and rulings received.
2. In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and reflected the change in the 2015 accounts. The adjustment reversed this treatment to show an underlying effective tax rate that was comparable with the prior year. The £77m excluded from profit before taxation comprised £50m included in non-recurring items relating to 2013 and 2014 (see note 1) and £27m included in underlying EBITA relating to 2015, of which £12m related to the Group's share of equity accounted investments. The £68m adjustment included £45m relating to the £50m included in non-recurring items.

6. Taxation expense continued

Tax recognised in other comprehensive income

	2016 Before tax £m	2016 Tax benefit/ (expense) £m	2016 Net of tax £m	2015[1] Before tax £m	2015[1] Tax (expense)/ benefit £m	2015[1] Net of tax £m
Items that will not be reclassified to the income statement:						
Subsidiaries:						
Remeasurements on retirement benefit schemes	**(1,468)**	**246**	**(1,222)**	864	(173)	691
Tax rate adjustment	**–**	**14**	**14**	–	(74)	(74)
Other	**–**	**–**	**–**	–	(11)	(11)
Equity accounted investments	**(66)**	**13**	**(53)**	21	(3)	18
Items that may be reclassified to the income statement:						
Subsidiaries:						
Currency translation on foreign currency net investments	**1,287**	**–**	**1,287**	260	–	260
Reclassification of cumulative currency translation reserve on disposal	**–**	**–**	**–**	20	–	20
Fair value loss on available-for-sale financial assets	**–**	**–**	**–**	(1)	–	(1)
Amounts credited/(charged) to hedging reserve	**96**	**(17)**	**79**	11	(2)	9
Equity accounted investments	**43**	**2**	**45**	(81)	7	(74)
	(108)	**258**	**150**	1,094	(256)	838

	2016 Other reserves £m	2016 Retained earnings £m	2016 Total £m	2015[1] Other reserves £m	2015[1] Retained earnings £m	2015[1] Total £m
Current tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	**–**	**27**	**27**	–	42	42
Other	**–**	**–**	**–**	–	(8)	(8)
	–	**27**	**27**	–	34	34
Deferred tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	**–**	**219**	**219**	–	(213)	(213)
Tax rate adjustment	**–**	**14**	**14**	–	(74)	(74)
Amounts charged to hedging reserve	**(17)**	**–**	**(17)**	(2)	–	(2)
Other	**–**	**–**	**–**	–	(5)	(5)
Equity accounted investments	**2**	**13**	**15**	7	(3)	4
	(15)	**246**	**231**	5	(295)	(290)
Tax on other comprehensive income	**(15)**	**273**	**258**	5	(261)	(256)

1. Re-presented in accordance with Amendments to IAS 1: Disclosure Initiative.

Notes to the Group accounts
continued

7. Earnings per share

Key Performance Indicator – Underlying earnings per share
Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items.

Purpose Provides a measure of underlying performance that is comparable over time.

	2016			2015		
	£m	**Basic pence per share**	**Diluted pence per share**	£m	Basic pence per share	Diluted pence per share
Profit for the year attributable to equity shareholders	**913**	**28.8**	**28.7**	918	29.0	28.9
Add back:						
Non-recurring items, post tax[1]	**9**			19		
Amortisation and impairment of intangible assets, post tax[1]	**69**			88		
Impairment of goodwill	**–**			75		
Net interest expense on retirement benefit obligations, post tax[1]	**140**			158		
Fair value and foreign exchange adjustments on financial instruments and investments, post tax[1]	**146**			12		
Underlying earnings, post tax	**1,277**	**40.3**	**40.1**	1,270	40.2	40.1

		Millions	**Millions**		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		**3,171**	**3,171**		3,161	3,161
Incremental shares in respect of employee share schemes			**14**			10
Weighted average number of shares used in calculating diluted earnings per share			**3,185**			3,171

1. The tax impact is calculated using the underlying effective tax rate of 21% (2015 21%).

8. Intangible assets

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

Cost or valuation

Goodwill

Under the acquisition method for business combinations, goodwill is the acquisition-date fair value of the consideration transferred, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Programme and customer-related

Intangible assets recognised by the Group include those relating to ongoing programmes within businesses acquired, mainly in respect of customer relationships and order backlog.

Other intangible assets

Other intangible assets include:

– **Computer software licences acquired** for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software;
– **Software development costs** that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Group-funded expenditure associated with enhancing or maintaining computer software programs for sale is recognised as an expense as incurred;
– **Research and development expenditure** funded by the Group on development activities applied to a plan or design for the production of new or substantially improved products is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads; and
– **Patents, trademarks and licences.**

Amortisation

Goodwill is not amortised. Amortisation on intangible assets, excluding goodwill, is charged to the income statement on a straight-line basis over their estimated useful lives.

For programme-related intangibles, amortisation is set on a programme-by-programme basis over the life of the individual programme. Amortisation for customer-related intangibles is also set on an individual basis.

The estimated useful lives are as follows:

Programme and customer-related	up to 15 years
Other intangible assets:	
Computer software licences acquired	2 to 5 years
Software development costs	2 to 5 years
Research and development expenditure	up to 10 years
Patents, trademarks and licences	up to 20 years
Other intangibles	up to 10 years

The Group has no indefinite-life intangible assets other than goodwill.

Impairment of intangible assets, property, plant and equipment, investment property and equity accounted investments

The carrying amounts of the Group's intangible assets (excluding goodwill), property, plant and equipment, investment property and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, Impairment of Assets. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet available for use, impairment testing is performed annually.

An impairment loss is recognised whenever the carrying amount of an asset or its Cash-Generating Unit exceeds its recoverable amount.

The recoverable amount is the greater of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate. For an asset that does not generate largely independent cash flows, the recoverable amount is determined for the Cash-Generating Unit to which the asset belongs.

Impairment losses are recognised in the income statement.

An impairment loss in respect of goodwill is not reversed. An impairment loss in respect of other intangible assets, property, plant and equipment, investment property and equity accounted investments is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised or if there has been a change in the estimate used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

Notes to the Group accounts
continued

8. Intangible assets continued

	Goodwill £m	Programme and customer-related £m	Other £m	Total £m
Cost or valuation				
At 1 January 2015	13,708	739	533	14,980
Additions:				
Acquired separately	–	–	42	42
Internally developed	–	–	12	12
Disposals[1]	–	(147)	(33)	(180)
Transfer from property, plant and equipment	–	–	5	5
Foreign exchange adjustments	333	12	8	353
At 31 December 2015	14,041	604	567	15,212
Additions:				
Acquired separately	–	–	81	81
Internally developed	–	–	1	1
Disposals[1]	–	(122)	(23)	(145)
Reclassification from held for sale	–	–	3	3
Transfer from property, plant and equipment	–	–	57	57
Foreign exchange adjustments	1,362	62	72	1,496
At 31 December 2016	**15,403**	**544**	**758**	**16,705**
Amortisation and impairment				
At 1 January 2015	4,044	609	344	4,997
Amortisation charge	–	61	43	104
Impairment charge	75	3	–	78
Disposals[1]	–	(147)	(33)	(180)
Foreign exchange adjustments	82	8	6	96
At 31 December 2015	4,201	534	360	5,095
Amortisation charge	–	32	51	83
Disposals[1]	–	(122)	(23)	(145)
Reclassification from held for sale	–	–	3	3
Foreign exchange adjustments	300	52	53	405
At 31 December 2016	**4,501**	**496**	**444**	**5,441**
Net book value				
At 31 December 2016	**10,902**	**48**	**314**	**11,264**
At 31 December 2015	9,840	70	207	10,117
At 1 January 2015	9,664	130	189	9,983

1. Includes intangible assets with nil net book value no longer used by the Group.

Impairment testing

The recoverable amount of the Group's goodwill is based on value in use estimated using risk-adjusted future cash flow projections from the five-year Integrated Business Plan (IBP) and a terminal value based on the projections for the final year of that plan, with growth rate assumptions in the range 0% to 2% applied. The IBP process includes the use of historical experience, available government spending data and the Group's order backlog. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.01% (2015 7.47%) (adjusted for risks specific to the market in which the Cash-Generating Unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.

8. Intangible assets continued

Significant CGUs

Goodwill allocated to CGUs, which are largely dependent on US government spending on defence, aerospace and security, represents £8.4bn (2015 £7.4bn) of the Group's total goodwill balance. The Group monitors changes in defence budgets on an ongoing basis.

		Allocated goodwill		Pre-tax discount rate	
Cash-Generating Unit	Key assumptions	**2016 £bn**	2015[1] £bn	**2016 %**	2015 %
Electronic Systems	Continued demand from the US government for electronic warfare systems (where the business has a leadership position), other technology-based solutions and growth in the commercial avionics market	**4.0**	3.7	**9**	10
Intelligence & Security (within Cyber & Intelligence)	Continued demand in the US for the Group's services in the areas of homeland security, law enforcement and counter-intelligence	**0.7**	0.6	**9**	10
Platforms & Services (US)	Continued demand in the Group's principal markets for existing and successor military tracked vehicles, naval guns, missile launchers, artillery systems, munitions, upgrade programmes and support, and in the US for complex infrastructure, maritime and aviation services	**3.7**	3.1	**9**	10

1. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2016 and the value-in-use calculations, for the CGUs listed above, is shown below. The table also shows the headroom assuming a 1% reduction in the terminal value growth rate assumption and a 1% increase in the discount rate used in the value-in-use calculations.

	Headroom as at 31 December		Headroom assuming a 1% reduction in the terminal value growth rate assumption		Headroom assuming a 1% increase in the discount rate	
Cash-Generating Unit	**2016 £bn**	2015 £bn	**2016 £bn**	2015 £bn	**2016 £bn**	2015 £bn
Electronic Systems	**3.5**	1.7	**2.2**	1.0	**2.0**	0.8
Intelligence & Security	**0.3**	–	**0.2**	(0.1)	**0.1**	(0.1)
Platforms & Services (US)	**1.6**	0.4	**0.7**	(0.1)	**0.5**	(0.3)

Other CGUs

The remaining goodwill balance of £2.5bn (2015 £2.4bn) is allocated across multiple CGUs, including £0.6bn (2015 £0.6bn) in the Applied Intelligence CGU, with no individual CGU exceeding 10% of the Group's total goodwill balance. The majority of the projected cash flows within these CGUs are underpinned by expected levels of primarily UK government spending on defence, aerospace and security, and the Group's ability to capture a broadly consistent market share. In the case of Applied Intelligence, the future cash flow projections are based on the expectation of growth in cyber and intelligence, in the UK and overseas government markets, together with increasing demand for products and services in commercial markets.

Impairment – goodwill

In 2015, the impairment charge of £75m in the Intelligence & Security CGU reflected lower business growth assumptions.

Impairment – intangible assets

In 2015, the impairment charge of £3m related to the Cyber & Intelligence reporting segment.

Notes to the Group accounts
continued

9. Property, plant and equipment

Cost
Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads. The cost of demonstration assets is written off as incurred. The reimbursement of the cost of an item of property, plant and equipment by a customer is presented as deferred income and recognised in the income statement on a basis consistent with the depreciation of the asset over its estimated useful life.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and impairment losses.

Depreciation
Depreciation is provided, normally on a straight-line basis, to write off the cost of items of property, plant and equipment over their estimated useful lives to any estimated residual value, using the following rates:

Buildings	up to 50 years, or the lease term if shorter
Plant and machinery:	
Computing equipment and motor vehicles	4 to 5 years
Other equipment	10 to 20 years, or the project life if shorter

For certain items of plant and equipment in the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically, this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

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

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date.

Impairment
The carrying amounts of the Group's property, plant and equipment are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 8.

9. Property, plant and equipment continued

	Land and buildings £m	Plant and machinery £m	Total £m
Cost			
At 1 January 2015	1,722	2,753	4,475
Additions[1]	108	284	392
Transfer to other intangible assets	–	(5)	(5)
Reclassification between categories	17	(17)	–
Disposals	(113)	(266)	(379)
Foreign exchange adjustments	36	57	93
At 31 December 2015	1,770	2,806	4,576
Additions[1]	235	326	561
Reclassification as held for sale	(20)	(2)	(22)
Transfer to investment properties	(9)	–	(9)
Transfer to other intangible assets	–	(57)	(57)
Reclassification between categories	28	(28)	–
Disposals	(22)	(72)	(94)
Foreign exchange adjustments	194	256	450
At 31 December 2016	**2,176**	**3,229**	**5,405**
Depreciation and impairment			
At 1 January 2015	963	1,923	2,886
Depreciation charge for the year	80	163	243
Impairment charge for the year	21	8	29
Reclassification between categories	2	(2)	–
Disposals	(80)	(261)	(341)
Foreign exchange adjustments	19	42	61
At 31 December 2015	1,005	1,873	2,878
Depreciation charge for the year	73	178	251
Impairment charge for the year	8	1	9
Reclassification as held for sale	(20)	(2)	(22)
Transfer to investment properties	(9)	–	(9)
Disposals	(13)	(70)	(83)
Foreign exchange adjustments	104	179	283
At 31 December 2016	**1,148**	**2,159**	**3,307**
Net book value			
At 31 December 2016	**1,028**	**1,070**	**2,098**
At 31 December 2015	765	933	1,698
At 1 January 2015	759	830	1,589

Net book value

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	869	–	869
Long leasehold property	18	–	18
Short leasehold property	141	–	141
Plant and machinery	–	998	998
Fixtures, fittings and equipment	–	72	72
At 31 December 2016	**1,028**	**1,070**	**2,098**

1. Includes £143m (2015 £44m) of land and buildings, and £25m (2015 £5m) of plant and machinery at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

Notes to the Group accounts continued

9. Property, plant and equipment continued

Impairment

	2016 £m	2015 £m
Cyber & Intelligence	–	1
Platforms & Services (US)	9	2
Platforms & Services (UK)	–	1
Platforms & Services (International)	–	25
	9	29

2016
The impairment in Platforms & Services (US) represents a charge against the carrying value of the BAE Systems San Francisco Ship Repair business sold in January 2017.

2015
The impairment in Platforms & Services (International) included a £24m charge against the carrying value of the Williamstown shipyard in Australia due to a reduction in workload.

Assets in the course of construction

	Land and buildings[1] £m	Plant and machinery[2] £m	Total £m
At 31 December 2016	**246**	**352**	**598**
At 31 December 2015	98	194	292

1. Includes £161m (2015 £42m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.
2. 2016 includes £106m in support of industrialisation in Saudi Arabia and £78m in respect of a new dry dock in San Diego, US, to support the US Navy's re-balance to the Asia-Pacific region.

Operating leases

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property – see note 10) are as follows:

	2016 £m	2015 £m
Receipts due:		
Not later than one year	25	25
Later than one year and not later than five years	90	93
Later than five years	72	94
	187	212

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

10. Investment property

Cost
Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and impairment losses.

Depreciation
Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Impairment
The carrying amounts of the Group's investment property are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 8.

	£m
Cost	
At 1 January 2015	186
Additions	13
Disposals	(23)
At 31 December 2015	176
Additions	9
Transfer from property, plant and equipment	9
Disposals	(24)
At 31 December 2016	**170**
Depreciation and impairment	
At 1 January 2015	57
Depreciation charge for the year	4
Impairment charge for the year	2
Disposals	(7)
At 31 December 2015	56
Depreciation charge for the year	2
Transfer from property, plant and equipment	9
Disposals	(7)
At 31 December 2016	**60**
Net book value	
At 31 December 2016	**110**
At 31 December 2015	120
At 1 January 2015	129

Fair value	
At 31 December 2016	**167**
At 31 December 2015	178

The fair values above are based on and reflect current market values as prepared by in-house professionals who have the appropriate professional qualifications and recent experience of valuing properties in the location and of the type being valued.

Notes to the Group accounts
continued

11. Equity accounted investments

A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets of the arrangement.

Carrying value
The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill, and is assessed for impairment as a single asset. The carrying amounts of the Group's equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 8.

Principal equity accounted investments

Joint venture	Principal activities	Shareholding	Principally operates in
Eurofighter Jagdflugzeug	Management and control of the European Typhoon programme	33%	Germany
MBDA	Development and manufacture of guided weapons	37.5%	Europe

The Group's 49% shareholding in Air Astana was previously classified as a principal equity accounted investment. The Group no longer considers Air Astana to be a principal equity accounted investment based on its share of Air Astana's revenue and profit, and its carrying value.

The following tables summarise the financial information of the Group's principal equity accounted investments included in their own financial statements, as adjusted for fair value adjustments at acquisition and differences in accounting policies, and reconcile this to the Group's interest in those equity accounted investments.

	2016		2015	
	Eurofighter Jagdflugzeug £m	**MBDA £m**	Eurofighter Jagdflugzeug £m	MBDA £m
Revenue (100%)	**2,986**	**2,416**	4,239	2,087
Underlying EBITA[1] excluding depreciation	**18**	**320**	24	282
Depreciation and amortisation	**(2)**	**(74)**	–	(60)
Financial income	**2**	**60**	2	59
Financial expense	**(9)**	**(77)**	(1)	(70)
Taxation expense	**(26)**	**(56)**	(7)	(53)
(Loss)/profit for the year (100%)	**(17)**	**173**	18	158
Remeasurements on retirement benefit schemes, net of tax	**–**	**(139)**	–	47
Amounts charged to hedging reserve, net of tax	**–**	**(30)**	–	–
Foreign exchange adjustments	**–**	**31**	–	1
Total comprehensive income for the year (100%)	**(17)**	**35**	18	206
Group's share of total comprehensive income for the year	**(5)**	**13**	6	77
Non-current assets	**11**	**1,996**	9	1,498
Cash and cash equivalents	**26**	**1,613**	4	1,047
Current assets excluding cash and cash equivalents	**1,746**	**3,870**	1,048	2,921
Current assets	**1,772**	**5,483**	1,052	3,968
Non-current financial liabilities excluding trade and other payables, and provisions	**–**	**(101)**	–	(7)
Other non-current liabilities	**(26)**	**(937)**	(19)	(742)
Non-current liabilities	**(26)**	**(1,038)**	(19)	(749)
Current financial liabilities excluding trade and other payables, and provisions	**–**	**(32)**	–	–
Other current liabilities	**(1,740)**	**(6,100)**	(1,011)	(4,421)
Current liabilities	**(1,740)**	**(6,132)**	(1,011)	(4,421)
Net assets (100%)	**17**	**309**	31	296

1. Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

11. Equity accounted investments continued

	2016			2015		
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Group's share of net assets	**5**	**116**	**121**	10	111	121
Elimination of unrealised profit	**–**	**–**	**–**	–	(4)	(4)
Goodwill	**–**	**5**	**5**	–	4	4
Carrying value	**5**	**121**	**126**	10	111	121

	2016			2015		
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Dividends received	**–**	**13**	**13**	6	17	23

Group summary
The Group also has a number of individually immaterial joint ventures, the carrying values of which at 31 December 2016 are as follows: Advanced Electronics Company (£47m), FADEC International (£37m), Air Astana (£31m) and Panavia Aircraft (£21m). The following table shows a reconciliation of opening to closing carrying value for both the Group's principal and immaterial joint ventures in aggregate.

	Principal equity accounted investments £m	Other £m	Total £m
At 1 January 2015	65	164	229
Group's share of profit for the year	65	45	110
Group's share of remeasurements on retirement benefit schemes	21	–	21
Tax on items that will not be reclassified to the income statement	(3)	–	(3)
Foreign exchange adjustments	–	(43)	(43)
Amounts charged to hedging reserve	–	(36)	(36)
Tax on items that may be reclassified to the income statement	–	7	7
Group's share of total comprehensive income for the year	83	(27)	56
Equity accounted investment funding	–	8	8
Dividends received from equity accounted investments	(23)	(18)	(41)
Foreign exchange adjustments	(4)	2	(2)
At 31 December 2015	121	129	250
Group's share of profit for the year	59	31	90
Group's share of remeasurements on retirement benefit schemes	(66)	–	(66)
Tax on items that will not be reclassified to the income statement	13	–	13
Foreign exchange adjustments	13	20	33
Amounts (charged)/credited to hedging reserve	(14)	5	(9)
Tax on items that may be reclassified to the income statement	3	(1)	2
Group's share of total comprehensive income for the year	8	55	63
Equity accounted investment funding	–	5	5
Dividends received from equity accounted investments	(13)	(25)	(38)
Foreign exchange adjustments	10	9	19
At 31 December 2016	**126**	**173**	**299**

Contingent liabilities
The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

Notes to the Group accounts
continued

12. Trade and other receivables

Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

A loss on provision for bad debt is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of long-term contract balances for that portion of the work which has already been completed, and the remainder is included as amounts due to long-term contract customers within trade and other payables. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to Group performance, as cash received on customers' account.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

	2016 £m	2015 £m
Non-current		
Prepayments and accrued income	**35**	23
US deferred compensation plan assets	**296**	234
Other receivables	**20**	18
	351	275
Current		
Long-term contract balances	**3,128**	4,407
Deduct Attributable progress payments	**(2,282)**	(3,762)
Amounts due from contract customers	**435**	413
Amounts due from customers for contract work	**1,281**	1,058
Trade receivables	**1,437**	1,284
Amounts owed by equity accounted investments (note 28)	**69**	75
Prepayments and accrued income	**256**	254
Other receivables	**262**	269
	3,305	2,940

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2016 is estimated to be £27.5bn (2015 £26.4bn).

Trade receivables are disclosed net of a provision for bad debts. Disclosures relating to the ageing of trade receivables and movements in the provision for bad debts are provided in note 26.

13. Other financial assets and liabilities

Derivative financial instruments and hedging activities

The international nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

The Group uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon.

The Group uses foreign exchange derivative instruments to manage the Group's exposure to currency fluctuations on its borrowings and deposits with the Group's subsidiaries and equity accounted investments.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes.

The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

Derivative financial instruments are recognised initially at fair value. Subsequent to initial recognition, such instruments are stated at fair value at the balance sheet date. The fair values are estimated by discounting expected future cash flows.

Fair value through profit or loss

Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement for the period.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately.

Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

	2016		2015	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**138**	**(102)**	52	(72)
Other foreign exchange/interest rate contracts	**93**	**–**	2	–
Debt-related derivative financial instruments – assets[1]	**114**	**–**	53	–
	345	**(102)**	107	(72)
Current				
Cash flow hedges – foreign exchange contracts	**151**	**(184)**	47	(123)
Other foreign exchange/interest rate contracts	**53**	**(28)**	58	(7)
	204	**(212)**	105	(130)

1. Includes fair value hedges of £4m (2015 £7m).

Cash flow hedges

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts credited to the hedging reserve in respect of cash flow hedges were £87m (2015 £25m charge), including £74m (2015 £54m) on reclassification to profit and loss and £13m (2015 £79m charge) on contracts held at 31 December 2016.

Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £3m (2015 gain £3m). The gain arising in the income statement on the fair value of the underlying hedged items was £1m (2015 loss £2m). The ineffective portion recognised as a loss in the income statement arising from fair value hedges was £2m (2015 gain £1m).

Debt-related derivative financial instruments

The debt-related derivative financial instruments represent the fair value of cross-currency and interest rate derivatives relating to the US$500m 7.5% bond, repayable 2027, and the US$800m 3.8% bond, repayable 2024, respectively (see note 18). These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Notes to the Group accounts
continued

14. Deferred tax

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

The most significant recognised deferred tax assets relate to the deficits on the Group's pension/retirement schemes (see below). This is because retirement benefit costs are deducted in determining accounting profit as service is provided by employees, but deducted in determining taxable profit either when contributions are paid to the pension/retirement schemes or when retirement benefits are paid. In reviewing the probability that taxable profits will be available in the future against which such contributions/payments can be deducted, account has been taken of the deficit recovery plans agreed with the trustees of the relevant schemes, which run until 2026.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different taxable entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2016 £m	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m
Property, plant and equipment	**20**	16	**(119)**	(101)	**(99)**	(85)
Intangible assets	**18**	13	**(28)**	(30)	**(10)**	(17)
Provisions and accruals	**343**	299	**–**	–	**343**	299
Goodwill	**–**	–	**(428)**	(326)	**(428)**	(326)
Pension/retirement schemes:						
Deficits	**1,212**	908	**–**	–	**1,212**	908
Additional contributions and other[1]	**149**	112	**–**	–	**149**	112
Share-based payments	**23**	15	**–**	–	**23**	15
Financial instruments	**–**	16	**(5)**	(6)	**(5)**	10
Other items	**39**	35	**–**	–	**39**	35
Rolled over capital gains	**–**	–	**(11)**	(12)	**(11)**	(12)
Capital losses carried forward	**11**	12	**–**	–	**11**	12
Trading losses carried forward	**17**	21	**–**	–	**17**	21
Deferred tax assets/(liabilities)	**1,832**	1,447	**(591)**	(475)	**1,241**	972
Set off of tax	**(581)**	(462)	**581**	462	**–**	–
Net deferred tax assets/(liabilities)	**1,251**	985	**(10)**	(13)	**1,241**	972

1. Includes deferred tax assets on US deferred compensation plans.

14. Deferred tax continued

Movement in temporary differences during the year

	At 1 January 2016 £m	Foreign exchange adjustments £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2016 £m**
Property, plant and equipment	(85)	(16)	2	–	**(99)**
Intangible assets	(17)	–	7	–	**(10)**
Provisions and accruals	299	54	(10)	–	**343**
Goodwill	(326)	(67)	(35)	–	**(428)**
Pension/retirement schemes:					
Deficits	908	45	26	233	**1,212**
Additional contributions and other[1]	112	24	13	–	**149**
Share-based payments	15	–	4	4	**23**
Financial instruments	10	1	1	(17)	**(5)**
Other items	35	6	(2)	–	**39**
Rolled over capital gains	(12)	–	1	–	**(11)**
Capital losses carried forward	12	–	(1)	–	**11**
Trading losses carried forward	21	1	(5)	–	**17**
	972	48	1	220	**1,241**

	At 1 January 2015 £m	Foreign exchange adjustments £m	Recognised in income £m	Recognised in equity £m	At 31 December 2015 £m
Property, plant and equipment	(78)	(6)	(1)	–	(85)
Intangible assets	(35)	(1)	19	–	(17)
Provisions and accruals	287	13	(1)	–	299
Goodwill	(273)	(17)	(36)	–	(326)
Pension/retirement schemes:					
Deficits	1,154	14	15	(275)	908
Additional contributions and other[1]	121	6	(3)	(12)	112
Share-based payments	21	–	(2)	(4)	15
Financial instruments	21	–	(8)	(3)	10
Other items	66	(1)	(30)	–	35
Rolled over capital gains	(13)	–	1	–	(12)
Capital losses carried forward	13	–	(1)	–	12
Trading losses carried forward	22	1	(2)	–	21
	1,306	9	(49)	(294)	972

1. Includes deferred tax assets on US deferred compensation plans.

Notes to the Group accounts continued

14. Deferred tax continued

Unrecognised deferred tax assets and liabilities

Deferred tax assets have not been recognised in respect of the following items:

	2016 Gross amount £m	2016 Unrecognised deferred tax asset £m	2015 Gross amount £m	2015 Unrecognised deferred tax asset £m
Deductible temporary differences, including tax credits	**2**	**2**	1	1
Capital losses carried forward	**165**	**30**	172	31
Trading and other losses carried forward	**415**	**39**	454	38
	582	**71**	627	70

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be accurately predicted at this time.

The Group has not recognised any deferred tax liability on temporary differences totalling £274m (2015 £243m) relating to potentially taxable unremitted earnings of overseas subsidiaries and equity accounted investments because any withholding tax due on the remittance of those earnings is expected to be insignificant.

Future changes in tax rates

The UK current tax rate reduced from 21% to 20% with effect from 1 April 2015 and will reduce to 19% with effect from 1 April 2017 and to 17% with effect from 1 April 2020. This will reduce future UK current tax charges accordingly.

Both recognised and unrecognised UK deferred tax balances as at 31 December 2016 have been calculated at a blended rate of 18%, which is the same rate used as at 31 December 2015.

15. Inventories

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

	2016 £m	2015 £m
Short-term work-in-progress	**416**	455
Raw materials and consumables	**256**	197
Finished goods and goods for resale	**72**	74
	744	726

The Group recognised £10m (2015 £16m) as a write down of inventories to net realisable value.

16. Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term deposits, investments in money market funds and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

	2016 £m	2015[1] £m
Cash	**419**	339
Money market funds	**869**	197
Short-term deposits	**1,483**	2,001
	2,771	2,537
Deduct Cash and cash equivalents (included within assets held for sale)	**(2)**	–
	2,769	2,537

1. Re-presented to show money market funds separately from cash.

17. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	2016 £m	2015 £m
UK		**2,755**	2,537
Rest of Europe		**586**	538
US		**9,864**	8,635
Saudi Arabia		**443**	349
Australia		**474**	406
Rest of Asia and Pacific		**6**	1
Non-current segment assets		**14,128**	12,466
Retirement benefit surpluses	20	**223**	193
Other financial assets	13	**549**	212
Tax		**1,256**	989
Inventories	15	**744**	726
Current trade and other receivables	12	**3,305**	2,940
Cash and cash equivalents	16	**2,769**	2,537
Assets held for sale		**2**	20
Consolidated total assets		**22,976**	20,083

18. Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at either amortised cost or, where hedge accounting has been adopted, fair value in respect of the hedged risk. Any difference between the amount initially recognised and the redemption value is recognised in the income statement over the period of the borrowings.

	2016 £m	2015 £m
Non-current		
Albertville Hangar bond, repayable 2018	**8**	6
US$1bn 6.375% bond, repayable 2019	**810**	680
US$500m 2.85% bond, repayable 2020	**403**	337
US$500m 4.75% bond, repayable 2021	**404**	339
£400m 4.125% bond, repayable 2022	**398**	398
US$800m 3.8% bond, repayable 2024	**649**	546
US$750m 3.85% bond, repayable 2025	**598**	501
US$500m 7.5% bond, repayable 2027	**402**	337
US$400m 5.8% bond, repayable 2041	**320**	268
US$550m 4.75% bond, repayable 2044	**433**	363
	4,425	3,775
Current		
US$350m 3.5% bond, repayable 2016	**–**	237
	–	237

US$500m of the US$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond by utilising interest rate swaps that mature in June 2019 and give an effective rate during 2016 of 6.0%.

US$500m of the US$800m 3.8% bond, repayable 2024, has been converted to a floating rate bond by utilising interest rate swaps that mature in October 2019 and give an effective rate during 2016 of 3.1%. US$500m of the US$800m bond is measured at amortised cost as adjusted for the fair value of the interest rate risk.

The US$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising cross-currency swaps and has an effective interest rate of 7.7%.

Notes to the Group accounts
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19. Trade and other payables

Trade and other payables are stated at their cost.

	2016 £m	2015 £m
Non-current		
Amounts due to long-term contract customers	**173**	456
Amounts due to other customers	**10**	8
Amounts owed to equity accounted investments (note 28)	**24**	32
Accruals and deferred income[1]	**300**	121
US deferred compensation plan liabilities	**326**	264
Other payables	**194**	139
	1,027	1,020
Current		
Amounts due to long-term contract customers	**3,084**	3,119
Amounts due to other customers	**169**	204
Trade payables	**707**	690
Amounts owed to equity accounted investments (note 28)	**726**	414
Other taxes and social security costs	**206**	155
Accruals and deferred income	**1,406**	1,371
Other payables	**242**	209
	6,540	6,162

Included above:		
Amounts due to long-term contract customers, including contract losses	**3,257**	3,575
Advances from long-term contract customers	**3,133**	3,416
Advances from other customers	**179**	212

1. Includes £209m (2015 £46m) of funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme.

20. Retirement benefits

Pension schemes

Defined contribution

Obligations for contributions are recognised as an expense in the income statement as incurred.

Defined benefit

The cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Remeasurements, including actuarial gains and losses, are recognised in the Consolidated statement of comprehensive income in the period in which they occur. Past service costs resulting from a plan amendment or curtailment are recognised immediately in the income statement.

The retirement benefit surpluses and obligations recognised in the Group's balance sheet represent the fair value of scheme assets, less the present value of the defined benefit obligations calculated using a number of actuarial assumptions as set out on page 158. The bid values of scheme assets are not intended to be realised in the short term and may be subject to significant change before they are realised. The present values of scheme liabilities are derived from cash flow projections over long periods and are, therefore, inherently uncertain.

IAS 19, Employee Benefits, limits the measurement of a defined benefit surplus to the lower of the surplus in the defined benefit scheme and the asset ceiling. The asset ceiling is the present value of any economic benefits available in the form of refunds from the scheme or reductions in future contributions to the scheme. IFRIC 14, IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, issued in 2007, provides an interpretation of the requirements of IAS 19, clarifying that a refund is available if the entity has an unconditional right to a refund in certain circumstances. The Group has applied IFRIC 14 and has determined that there is no limit on the recognition of the surpluses in its defined benefit pension schemes as at 31 December 2016.

Certain of the Group's equity accounted investments participate in the Group's defined benefit schemes and, as these are multi-employer schemes, the Group has allocated a share of the IAS 19 pension surpluses and deficits to its equity accounted investments.

On 1 April 2016, a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) was created, reducing the total net IAS 19 deficit, with a corresponding reduction in the allocation to equity accounted investments. There was no settlement gain or loss upon sectionalisation of the Main Scheme.

The deficit allocation methodology for the remaining employers of the Main Scheme and for all other schemes is based on the relative payroll contributions of active members, which is consistent with prior years. Whilst this methodology is intended to reflect a reasonable estimate of the share of the deficit, it may not accurately reflect the obligations of the participating employers.

In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote. However, following the creation of an Airbus section of the Main Scheme, the Group's obligation in respect of Airbus has been removed in respect of the Main Scheme.

The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments.

Pension schemes

Background

BAE Systems plc operates pension schemes for the Group's qualifying employees in the UK, US and other countries. The principal schemes in the UK and US are funded defined benefit schemes, and the assets are held in separate trustee-administered funds. The two largest funded defined benefit schemes are the Main Scheme and the BAE Systems 2000 Pension Plan (2000 Plan) which, in aggregate, represent 69% (2015 71%) of the total IAS 19 defined benefit obligation at 31 December 2016. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2016, the weighted average durations of the UK and US defined benefit pension obligations were 19 years (2015 18 years) and 12 years (2015 12 years), respectively.

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme, 2000 Plan and US schemes in aggregate is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme[1]	32	19	49
2000 Plan[2]	14	29	57
US schemes[3]	32	17	51

1. Source: Main Scheme actuarial valuation report as at 31 March 2014.
2. Source: 2000 Plan actuarial valuation report as at 31 March 2014.
3. Source: Annual updates of the US schemes as at 1 January 2016.

Notes to the Group accounts
continued

20. Retirement benefits continued

Regulatory framework
The funded UK schemes are registered and subject to the statutory scheme specific-funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and the Group.

The funded US schemes are tax-qualified pension schemes regulated by the Pension Protection Act 2006 and insured by the Pension Benefit Guarantee Corporation (PBGC) up to certain limits. These schemes were established under and are governed by the US Employee Retirement Income Security Act 1974 and the BAE Systems Administrative Committee is a named fiduciary with the authority to manage their operation.

Benefits
The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The Normal Retirement Age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: baesystemspensions.com.

The US defined benefit schemes ceased to be final salary schemes in January 2013. The benefits accrued based on the final salaries of members at that point will become payable on retirement. The Normal Retirement Age for the largest scheme in the US is 65.

Funding
The majority of the UK and US defined benefit pension schemes are funded by the Group's subsidiaries and equity accounted investments. The individual pension schemes' funding requirements are based on actuarial measurement frameworks set out in their funding policies.

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

The separate actuarial valuations for funding purposes include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 158. The latest valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2014 and showed a funding deficit of £2.6bn. The total net funding deficit in respect of all of the UK schemes was £2.7bn. Deficit recovery plans agreed with the trustees of the relevant schemes run until 2026.

The next UK triennial funding valuations, as at 31 March 2017, will commence in April 2017 and, in conjunction with the trustees of the schemes and other stakeholders, the Group will be looking at various options with a focus on the longer-term view. The results of future triennial valuations and associated funding requirements will be impacted by the future performance of investment markets, and interest and inflation rates.

The total Group contributions made to the defined benefit schemes in the year ended 31 December 2016 were £411m (2015 £438m) excluding those amounts allocated to equity accounted investments of £50m (2015 £98m). Equity accounted investments make regular contributions to the schemes in which they participate in line with the schedule of contributions and are allocated a share of deficit funding contributions.

In 2017, the Group expects to make contributions at a similar level to the recurring contributions and deficit funding as made in 2016.

The Group incurred a charge of £163m (2015 £140m) in relation to defined contribution schemes for employees.

20. Retirement benefits continued

Risk management

The defined benefit pension schemes expose the Group to actuarial risks, including market (investment) risk, interest rate risk, inflation risk and longevity risk.

Risk	Mitigation
Market (investment) risk	
Asset returns may not move in line with the liabilities and may be subject to volatility.	The investment portfolios are highly diversified, investing in a wide range of assets, in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities. Some 47% (2015 49%) of the Group's pension scheme assets are held in equities and pooled investment vehicles due to the higher expected level of return over the long term. Some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of market risk. In August 2013, the Main Scheme implemented a long-dated equity option strategy protecting £1.4bn of assets against a significant fall in equity markets.
Interest rate risk	
Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, some of the UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk. The Group is hedged against approximately 35% of interest rate risk.
Inflation risk	
Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk. The Group is hedged against approximately 40% of inflation risk. Effective 1 May 2014, the Main Scheme implemented a pension increase exchange to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases.
Longevity risk	
Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees. In February 2013, with the agreement of the Company, the trustees of the 2000 Plan entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. In December 2013, similar arrangements were entered into, with Legal & General, by the trustees of the Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme, covering £0.9bn and £0.8bn of pension scheme liabilities, respectively. These arrangements reduce the funding volatility relating to increasing life expectancy.

Notes to the Group accounts continued

20. Retirement benefits continued

Principal actuarial assumptions

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the long-term nature of the obligation covered, may not necessarily occur in practice.

	UK			US		
	2016	2015	2014	**2016**	2015	2014
Financial assumptions						
Discount rate (%)	**2.7**	3.9	3.6	**4.2**	4.5	4.1
Inflation (%)	**3.2**	3.2	3.2	**n/a**	n/a	n/a
Rate of increase in salaries (%)	**3.2**	3.2	3.2	**n/a**	n/a	n/a
Rate of increase in deferred pensions (%)	**2.2/3.2**	2.3/3.2	2.3/3.2	**n/a**	n/a	n/a
Rate of increase in pensions in payment (%)	**1.7 – 3.7**	1.8 – 3.6	1.8 – 3.6	**n/a**	n/a	n/a
Demographic assumptions						
Life expectancy of a male currently aged 65 (years)	**86 – 89**	87 – 89	87 – 89	**87**	87	87
Life expectancy of a female currently aged 65 (years)	**89 – 90**	89 – 90	89 – 90	**89**	89	89
Life expectancy of a male currently aged 45 (years)	**88 – 91**	89 – 91	89 – 91	**87**	87	87
Life expectancy of a female currently aged 45 (years)	**91 – 92**	91 – 92	91 – 92	**89**	89	89

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments of the principal schemes using a third-party AA corporate bond yield curve to produce a single equivalent discount rate for the UK and US territories. This inherently captures the maturity profile of the expected benefit payments. Further information on the duration of the schemes is detailed on page 155.

Inflation

In the UK, the inflation assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information. In the US, inflation assumptions are not significant as the Group's US pension schemes are not indexed with inflation.

Rate of increase in salaries

The rate of increase in salaries for the UK schemes is assumed to be Retail Prices Index (RPI) inflation of 3.2% (2015 RPI inflation of 3.2%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on Consumer Prices Index (CPI) inflation of 2.2% (2015 CPI inflation of 2.3%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.2% (2015 RPI inflation of 3.2%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

Rate of increase in pensions in payment

The rate of increase in pensions in payment differs between UK schemes. Different tranches of the schemes increase at rates based on either RPI or CPI inflation, and some are subject to an inflation cap. With the exception of two smaller schemes, the rate of increase in pensions in payment is based on RPI inflation.

Life expectancy

For its UK pension schemes, the Group has used the Self-Administered Pension Schemes S2 mortality tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of scheme members. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2015 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1.25% (2015 1.25%), for both pensioner and non-pensioner members.

In October 2015, the Society of Actuaries in the US released updated mortality assumptions reflecting the results of its comprehensive mortality study. For the majority of the US schemes, the mortality tables used at 31 December 2016 are a blend of the fully generational RP-2014 Aggregate table and the RP-2014 White Collar table, both projected using Scale MP-2016. IRS approval of the mortality tables is expected in 2017, following which the tables are expected to be adopted for funding valuation purposes.

20. Retirement benefits continued

Retirement benefits other than pensions

Background

The Group operates a number of non-pension retirement benefit schemes, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal schemes, covering retiree medical and life insurance schemes in certain US subsidiaries, were performed by independent actuaries as at 1 January 2016. These valuations were rolled forward to reflect the information at 31 December 2016. The method of accounting for these is similar to that used for defined benefit pension schemes.

Principal actuarial assumptions

The assumption for long-term healthcare cost increases is 4.8% (2015 4.8%) based on the assumptions that the increases are 6.5% in 2016 reducing to 4.5% by 2024 and 4.5% each year thereafter for pre-retirement, and 5.5% in 2016 reducing to 4.5% by 2024 and 4.5% each year thereafter for post-retirement.

The disclosures below relate to post-retirement benefit schemes in the UK, US and other countries which are accounted for as defined benefit schemes in accordance with IAS 19.

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total net IAS 19 deficit at 1 January 2016	(4,824)	(730)	(5,554)
Impact of sectionalisation of the Main Scheme[1]	667	–	667
	(4,157)	(730)	(4,887)
Actual return on assets excluding amounts included in net interest expense	2,649	180	2,829
Increase in liabilities due to changes in financial assumptions	(4,815)	(170)	(4,985)
Decrease in liabilities due to changes in demographic assumptions	250	40	290
Experience gains	242	10	252
Additional contributions in excess of service cost	164	–	164
Recurring contributions in excess of service cost	46	43	89
Past service cost – plan amendments	(7)	(4)	(11)
Net interest expense	(150)	(34)	(184)
Foreign exchange adjustments	–	(135)	(135)
Movement in US healthcare schemes	–	8	8
Total net IAS 19 deficit at 31 December 2016	**(5,778)**	**(792)**	**(6,570)**
Allocated to equity accounted investments	516	–	516
Group's share of net IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments at 31 December 2016	**(5,262)**	**(792)**	**(6,054)**

1. The Main Scheme deficit allocated to Airbus at 31 December 2015 of £683m as adjusted for a £16m contribution into the scheme by Airbus in the first quarter of 2016.

The increase in liabilities due to changes in financial assumptions in the UK schemes reflects a 1.2 percentage point decrease in the real discount rate to –0.5%.

Notes to the Group accounts continued

20. Retirement benefits continued

Amounts recognised on the balance sheet

The table below shows a reconciliation between the gross assets and liabilities of the Group's UK, US and other post-retirement benefit schemes and the amounts recognised on the Group's balance sheet after allocation to equity accounted investments.

	2016				2015			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Present value of unfunded obligations	**(74)**	**(153)**	**–**	**(227)**	(59)	(131)	–	(190)
Present value of funded obligations	**(27,099)**	**(4,981)**	**(169)**	**(32,249)**	(24,974)	(4,072)	(145)	(29,191)
Fair value of scheme assets	**21,395**	**4,313**	**198**	**25,906**	20,209	3,452	166	23,827
Total net IAS 19 (deficit)/surplus	**(5,778)**	**(821)**	**29**	**(6,570)**	(4,824)	(751)	21	(5,554)
Allocated to equity accounted investments	**516**	**–**	**–**	**516**	1,053	–	–	1,053
Group's share of net IAS 19 (deficit)/surplus	**(5,262)**	**(821)**	**29**	**(6,054)**	(3,771)	(751)	21	(4,501)
Represented by:								
Retirement benefit surpluses	**132**	**49**	**42**	**223**	120	41	32	193
Retirement benefit obligations	**(5,394)**	**(870)**	**(13)**	**(6,277)**	(3,891)	(792)	(11)	(4,694)
	(5,262)	**(821)**	**29**	**(6,054)**	(3,771)	(751)	21	(4,501)
Group's share of net IAS 19 deficit of equity accounted investments	**(193)**	**–**	**–**	**(193)**	(139)	–	–	(139)

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £6.7bn (2015 £5.2bn).

Changes in the fair value of scheme assets before allocation to equity accounted investments

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Value of scheme assets at 1 January 2015	20,170	3,505	165	23,840
Interest income	720	142	7	869
Actual return on assets excluding amounts included in interest income	(335)	(198)	(9)	(542)
Actual return on assets	385	(56)	(2)	327
Contributions by employer	460	76	2	538
Contributions by employer in respect of employee salary sacrifice arrangements	103	–	–	103
Total contributions by employer	563	76	2	641
Members' contributions	11	–	–	11
Administrative expenses	–	(12)	(1)	(13)
Settlements	–	(64)	–	(64)
Foreign exchange translation	–	190	9	199
Benefits paid	(920)	(187)	(7)	(1,114)
Value of scheme assets at 31 December 2015	20,209	3,452	166	23,827
Impact of sectionalisation of the Main Scheme	(1,779)	–	–	(1,779)
Interest income	710	166	8	884
Actual return on assets excluding amounts included in interest income	2,649	180	2	2,831
Actual return on assets	3,359	346	10	3,715
Contributions by employer	390	71	1	462
Contributions by employer in respect of employee salary sacrifice arrangements	86	–	–	86
Total contributions by employer	476	71	1	548
Members' contributions	9	–	–	9
Administrative expenses	–	(17)	–	(17)
Foreign exchange translation	–	679	33	712
Benefits paid	(879)	(218)	(12)	(1,109)
Value of scheme assets at 31 December 2016	**21,395**	**4,313**	**198**	**25,906**

20. Retirement benefits continued

Assets of defined benefit pension schemes

	2016								
	UK			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK[1]	**4,030**	**–**	**4,030**	**–**	**–**	**–**	**4,030**	**–**	**4,030**
Overseas	**2,774**	**–**	**2,774**	**430**	**–**	**430**	**3,204**	**–**	**3,204**
Pooled investment vehicles[2]	**1,503**	**2,428**	**3,931**	**988**	**–**	**988**	**2,491**	**2,428**	**4,919**
Fixed interest securities:									
UK gilts	**1,947**	**–**	**1,947**	**–**	**–**	**–**	**1,947**	**–**	**1,947**
UK corporates	**2,389**	**145**	**2,534**	**–**	**–**	**–**	**2,389**	**145**	**2,534**
Overseas government	**79**	**–**	**79**	**151**	**–**	**151**	**230**	**–**	**230**
Overseas corporates	**1,069**	**230**	**1,299**	**2,509**	**–**	**2,509**	**3,578**	**230**	**3,808**
Index-linked securities:									
UK gilts	**2,039**	**–**	**2,039**	**–**	**–**	**–**	**2,039**	**–**	**2,039**
UK corporates	**1,046**	**546**	**1,592**	**–**	**–**	**–**	**1,046**	**546**	**1,592**
Property[3]	**–**	**1,460**	**1,460**	**–**	**147**	**147**	**–**	**1,607**	**1,607**
Derivatives[4]	**–**	**(708)**	**(708)**	**–**	**–**	**–**	**–**	**(708)**	**(708)**
Cash:									
Sterling	**345**	**–**	**345**	**–**	**–**	**–**	**345**	**–**	**345**
Foreign currency	**32**	**26**	**58**	**79**	**–**	**79**	**111**	**26**	**137**
Other	**–**	**15**	**15**	**–**	**9**	**9**	**–**	**24**	**24**
Total	**17,253**	**4,142**	**21,395**	**4,157**	**156**	**4,313**	**21,410**	**4,298**	**25,708**

	2015								
	UK[5,6]			US and other			Total[5,6]		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK[1]	4,133	–	4,133	–	–	–	4,133	–	4,133
Overseas	2,883	–	2,883	602	–	602	3,485	–	3,485
Pooled investment vehicles[2]	1,172	2,247	3,419	480	–	480	1,652	2,247	3,899
Fixed interest securities:									
UK gilts	2,103	–	2,103	–	–	–	2,103	–	2,103
UK corporates	2,534	237	2,771	–	–	–	2,534	237	2,771
Overseas government	–	–	–	111	–	111	111	–	111
Overseas corporates	184	205	389	2,084	–	2,084	2,268	205	2,473
Index-linked securities:									
UK gilts	1,754	–	1,754	–	–	–	1,754	–	1,754
UK corporates	1,074	604	1,678	–	–	–	1,074	604	1,678
Property[3]	–	1,433	1,433	–	146	146	–	1,579	1,579
Derivatives[4]	–	(678)	(678)	–	–	–	–	(678)	(678)
Cash:									
Sterling	253	–	253	–	–	–	253	–	253
Foreign currency	44	13	57	23	–	23	67	13	80
Other	–	14	14	–	6	6	–	20	20
Total	16,134	4,075	20,209	3,300	152	3,452	19,434	4,227	23,661

1. Includes £32m (2015 £31m) of the Company's own ordinary shares.
2. Primarily invested in equities. The amounts classified as unquoted primarily comprise investments in private equity, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.
3. Valued on the basis of open market value at the end of the year determined in accordance with the Royal Institution of Chartered Surveyors' Appraisal and Valuation Standards and the Practice Note contained therein. Includes £229m (2015 £257m) of property occupied by Group companies.
4. Includes interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.
5. 2015 assets are prior to sectionalisation of the Main Scheme.
6. Restated following reinterpretation of the classifications, including the allocation between quoted and unquoted assets.

Notes to the Group accounts
continued

20. Retirement benefits continued

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Defined benefit obligations at 1 January 2015	(26,236)	(4,270)	(146)	(30,652)
Current service cost	(239)	(11)	(2)	(252)
Contributions by employer in respect of employee salary sacrifice arrangements	(103)	–	–	(103)
Total current service cost	(342)	(11)	(2)	(355)
Members' contributions	(11)	–	–	(11)
Past service cost – plan amendments	(10)	–	–	(10)
Settlements	–	68	–	68
Actuarial gain due to changes in financial assumptions	1,348	202	7	1,557
Actuarial gain due to changes in demographic assumptions	–	29	2	31
Experience gains/(losses)	224	(4)	1	221
Interest expense	(926)	(174)	(6)	(1,106)
Foreign exchange translation	–	(230)	(8)	(238)
Benefits paid	920	187	7	1,114
Defined benefit obligations at 31 December 2015	(25,033)	(4,203)	(145)	(29,381)
Impact of sectionalisation of the Main Scheme	2,446	–	–	2,446
Current service cost	(180)	(11)	(1)	(192)
Contributions by employer in respect of employee salary sacrifice arrangements	(86)	–	–	(86)
Total current service cost	(266)	(11)	(1)	(278)
Members' contributions	(9)	–	–	(9)
Past service cost – plan amendments	(7)	(4)	(1)	(12)
Actuarial loss due to changes in financial assumptions	(4,815)	(170)	(5)	(4,990)
Actuarial gain due to changes in demographic assumptions	250	40	3	293
Experience gains	242	10	1	253
Interest expense	(860)	(200)	(7)	(1,067)
Foreign exchange translation	–	(814)	(26)	(840)
Benefits paid	879	218	12	1,109
Defined benefit obligations at 31 December 2016	**(27,173)**	**(5,134)**	**(169)**	**(32,476)**

Amounts recognised in the income statement after allocation to equity accounted investments

	2016				2015			
	UK defined benefit pension schemes £m	**US and other pension schemes £m**	**US healthcare schemes £m**	**Total £m**	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Included in operating costs:								
Current service cost	**(161)**	**(11)**	**(1)**	**(173)**	(177)	(11)	(2)	(190)
Past service cost – plan amendments	**(7)**	**(4)**	**(1)**	**(12)**	(10)	–	–	(10)
Settlements	**–**	**–**	**–**	**–**	–	4	–	4
	(168)	**(15)**	**(2)**	**(185)**	(187)	(7)	(2)	(196)
Administrative expenses	**–**	**(17)**	**–**	**(17)**	–	(12)	(1)	(13)
	(168)	**(32)**	**(2)**	**(202)**	(187)	(19)	(3)	(209)
Included in net finance costs:								
Net interest (expense)/income on retirement benefit obligations	**(136)**	**(34)**	**1**	**(169)**	(161)	(32)	1	(192)
Group defined benefit schemes included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	**(10)**	**–**	**–**	**(10)**	(10)	–	–	(10)
Group's share of equity accounted investments' finance costs	**(5)**	**–**	**–**	**(5)**	(6)	–	–	(6)

20. Retirement benefits continued

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2016 and keeping all other assumptions as set out on page 158.

Financial assumptions

Changes in the following financial assumptions would have the following effect on the defined benefit pension obligation before allocation to equity accounted investments:

	(Increase)/decrease in pension obligation £bn
Discount rate:	
0.1 percentage point increase	0.6
0.1 percentage point decrease	(0.6)
Inflation:	
0.1 percentage point increase	(0.5)
0.1 percentage point decrease	0.5

The sensitivity analysis does not allow for the impact of the Group's risk management activities in respect of interest rate and inflation risk (see page 157) on the valuation of the scheme assets. Across all of its pension schemes, the Group is hedged against approximately 35% and 40% of interest rate and inflation risk, respectively, measured relative to the funding liabilities. The Group's US schemes are not indexed with inflation. The table below shows the estimated impact of changes in the following financial assumptions allowing for the impact of the Group's risk management activities in respect of interest rate and inflation risk swaps, together with the impact on the matched asset portfolio. It does not reflect any natural matching that occurs in the wider asset portfolio:

	(Increase)/decrease in pension obligation £bn	(Increase)/decrease in scheme assets £bn
Discount rate:		
0.1 percentage point increase	0.6	(0.2)
0.1 percentage point decrease	(0.6)	0.2
Inflation:		
0.1 percentage point increase	(0.5)	0.2
0.1 percentage point decrease	0.5	(0.2)

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions (rate of increase in salaries, rate of increase in deferred pensions and rate of increase in pensions in payment) used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/decrease in pension obligation £bn
Inflation:	
0.5 percentage point increase	(1.8)
0.5 percentage point decrease	1.6
1.0 percentage point increase	(3.5)
1.0 percentage point decrease	3.0

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 157), would have the following effect on the total net IAS 19 deficit:

	(Increase)/decrease in net deficit £bn
Life expectancy:	
One-year increase	(1.1)
One-year decrease	1.1

Notes to the Group accounts
continued

21. Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

Warranties and after-sales service
Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of possible outcomes against their associated probabilities.

Reorganisations
A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Future operating costs are not provided for.

Legal, contractual and environmental
The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period. Management exercises judgement to determine the amount of these provisions. Provision is made for known issues based on past experience of similar items and other known factors. Each provision is considered separately and the amount provided reflects the best estimate of the most likely amount, being the single most likely amount in a range of possible outcomes.

	Warranties and after-sales service £m	Reorganisations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	48	–	278	28	354
Current	37	65	151	48	301
At 1 January 2016	85	65	429	76	655
Created	55	13	44	27	139
Utilised	(31)	(36)	(48)	(19)	(134)
Released[1]	(16)	(21)	(62)	(26)	(125)
Net present value adjustments	–	–	16	3	19
Foreign exchange adjustments	9	2	32	9	52
At 31 December 2016	**102**	**23**	**411**	**70**	**606**
Represented by:					
Non-current	59	1	280	32	372
Current	43	22	131	38	234
	102	**23**	**411**	**70**	**606**

1. There are no individual provision releases in excess of £10m.

Warranties and after-sales service
Warranty and after-sales service costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum, but not the timing, of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations
Reorganisation costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

Legal, contractual and environmental
Reflecting the inherent uncertainty within many legal proceedings, the amount of the outflows could differ significantly from the amount provided.

Other
There are no individually significant provisions included within other provisions.

22. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2015	3,469	87	1	1	87
Repurchased and cancelled	(2)	–	–	–	–
At 31 December 2015 and 31 December 2016	**3,467**	**87**	**1**	**1**	**87**

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Energy and Industrial Strategy (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders, but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Share buyback

In 2015, 1,450,000 ordinary shares of 2.5p were repurchased under the three-year buyback programme announced in February 2013 and such repurchased shares were cancelled.

Treasury shares

As at 31 December 2016, 291,449,361 (2015 301,808,103) ordinary shares of 2.5p each with an aggregate nominal value of £7,286,234 (2015 £7,545,203) were held in treasury. During 2016, 10,358,742 (2015 14,018,511) treasury shares were used to satisfy awards and options under the Share Incentive Plan, International Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan.

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems Employee Share Option Plan (ESOP) Trust, are recognised as a deduction from retained earnings.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. Dividend waivers were in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and November 2016.

At 31 December 2016, the ESOP held 1,327,731 (2015 897,873) ordinary shares of 2.5p each, with a market value of £8m (2015 £4m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was also in operation for the dividends paid in June and November 2016 over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

Equity dividends

Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

	2016 £m	2015 £m
Prior year final 12.5p dividend per ordinary share paid in the year (2015 12.3p)	**397**	389
Interim 8.6p dividend per ordinary share paid in the year (2015 8.4p)	**273**	266
	670	655

After the balance sheet date, the directors proposed a final dividend of 12.7p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 1 June 2017 to shareholders registered on 21 April 2017. The ex-dividend date is 20 April 2017.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2017.

Notes to the Group accounts
continued

22. Share capital and other reserves continued

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Capital redemption reserve £m	Hedging reserve £m	Translation reserve £m	Total £m
At 1 January 2015	4,589	202	10	3	(42)	299	5,061
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	261	261
Reclassification of cumulative currency translation reserve on disposal	–	–	–	–	–	20	20
Amounts credited to hedging reserve[1]	–	–	–	–	11	–	11
Tax on other comprehensive income[1]	–	–	–	–	(2)	–	(2)
Equity accounted investments (net of tax)[1]	–	–	–	–	(29)	(45)	(74)
At 31 December 2015	4,589	202	10	3	(62)	535	5,277
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	1,284	1,284
Amounts credited to hedging reserve	–	–	–	–	96	–	96
Tax on other comprehensive income	–	–	–	–	(17)	–	(17)
Equity accounted investments (net of tax)	–	–	–	–	(7)	52	45
At 31 December 2016	**4,589**	**202**	**10**	**3**	**10**	**1,871**	**6,685**

1. Re-presented in accordance with Amendments to IAS 1: Disclosure Initiative.

Merger reserve
The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

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

Revaluation reserve
The revaluation reserve relates to the revaluation at fair value of the net assets of the BVT joint venture previously held as an equity accounted investment on the acquisition of the remaining 45% interest in 2009.

Capital redemption reserve
The capital redemption reserve represents the cumulative nominal value of the Company's ordinary shares repurchased and subsequently cancelled.

Hedging reserve
The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Translation reserve
The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

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

At 31 December 2016, the Group's capital was £3,454m (2015 £3,064m), which comprises total equity of £3,464m (2015 £3,002m), excluding amounts accumulated in equity relating to cash flow hedges of £10m (2015 liability £62m). Net debt was £1,542m (2015 £1,422m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating and ensure operating flexibility, whilst:

- meeting its pension obligations;
- pursuing organic investment opportunities;
- paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings (see note 7);
- making accelerated returns of capital to shareholders when the balance sheet allows and when the return from doing so is in excess of the Group's Weighted Average Cost of Capital; and
- investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.

23. Operating business cash flow

Key Performance Indicator – Operating business cash flow
Definition Net cash flow from operating activities excluding taxation after net capital expenditure, financial investment and dividends from equity accounted investments.

Purpose Allows management to monitor the operating cash generation of the Group.

Reconciliation of net cash flow from operating activities to operating business cash flow

	2016 £m	2015 £m
Net cash flow from operating activities	**1,229**	808
Add back Taxation paid	**187**	116
Purchase of property, plant and equipment, and investment property	**(408)**	(359)
Purchase of intangible assets	**(82)**	(54)
Proceeds from sale of property, plant and equipment, and investment property	**45**	136
Proceeds from sale of non-current other investments	**–**	1
Equity accounted investment funding	**(5)**	(8)
Net capital expenditure and financial investment	**(450)**	(284)
Dividends received from equity accounted investments	**38**	41
Operating business cash flow	**1,004**	681

Reconciliation of operating business cash flow to net cash flow from operating activities by reporting segment

	Operating business cash flow		Deduct Dividends received from equity accounted investments		Add back Net capital expenditure and financial investment		Net cash flow from operating activities	
	2016 £m	2015[1] £m	**2016 £m**	2015 £m	**2016 £m**	2015[1] £m	**2016 £m**	2015[1] £m
Electronic Systems	**469**	370	**(2)**	(1)	**101**	76	**568**	445
Cyber & Intelligence	**83**	46	**–**	–	**23**	24	**106**	70
Platforms & Services (US)	**58**	100	**(9)**	(6)	**80**	50	**129**	144
Platforms & Services (UK)	**199**	220	**(3)**	(6)	**189**	75	**385**	289
Platforms & Services (International)	**435**	164	**(19)**	(26)	**57**	55	**473**	193
HQ	**(240)**	(219)	**(5)**	(2)	**–**	4	**(245)**	(217)
	1,004	681	**(38)**	(41)	**450**	284	**1,416**	924
Taxation paid[2]							**(187)**	(116)
Net cash flow from operating activities							**1,229**	808

1. Re-presented for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business from Cyber & Intelligence to Electronic Systems.
2. Taxation is managed on a Group basis.

Notes to the Group accounts
continued

24. Net debt

Key Performance Indicator – Net debt
Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments).

Purpose Allows management to monitor the net cash generation of the Group.

Components of net debt

	Notes	2016 £m	2015 £m
Cash and cash equivalents	16	**2,769**	2,537
Debt-related derivative financial instrument assets – non-current	13	**114**	53
Loans – non-current	18	**(4,425)**	(3,775)
Loans and overdrafts – current	18	**–**	(237)
Net debt		**(1,542)**	(1,422)

25. Fair value measurement

Fair value of financial instruments

Certain of the Group's financial instruments are held at fair value.

The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date.

The fair values of financial instruments held at fair value have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair values of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair values of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates; and
- the fair values of loans and overdrafts have been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at 31 December may not be indicative of the amounts the Group would expect to realise in the current market environment.

Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

25. Fair value measurement continued

Carrying amounts and fair values of certain financial instruments

	Notes	2016 Carrying amount £m	2016 Fair value £m	2015 Carrying amount £m	2015 Fair value £m
Financial instruments measured at fair value:					
Non-current					
Available-for-sale financial assets		**6**	**6**	6	6
Other receivables[1]	12	**296**	**296**	234	234
Other financial assets	13	**345**	**345**	107	107
Other financial liabilities	13	**(102)**	**(102)**	(72)	(72)
Other payables[1]	19	**(326)**	**(326)**	(264)	(264)
Current					
Other financial assets	13	**204**	**204**	105	105
Other financial liabilities	13	**(212)**	**(212)**	(130)	(130)
Financial instruments not measured at fair value:					
Non-current					
Loans[2]	18	**(4,425)**	**(4,805)**	(3,775)	(4,050)
Current					
Cash and cash equivalents	16	**2,769**	**2,769**	2,537	2,537
Loans and overdrafts	18	**–**	**–**	(237)	(241)

1. Represents US deferred compensation plan assets and liabilities.
2. US$500m of the US$800m 3.8% bond, repayable 2024, has been converted to a floating rate bond by utilising interest rate swaps. These derivatives have been designated as fair value hedges. Changes in the fair value of the interest rate risk on the bond, and gains and losses on the derivatives are recognised in the income statement. The bond has been included in financial instruments not measured at fair value because its carrying value has only been adjusted for the fair value of the interest rate risk on a portion of the bond.

All of the financial assets and liabilities measured at fair value are classified as level 2 using the fair value hierarchy. There were no transfers between levels during the year.

Financial assets and liabilities in the Group's Consolidated balance sheet are either held at fair value or their carrying value approximates to fair value, with the exception of loans, most of which are held at amortised cost.

Notes to the Group accounts continued

26. Financial risk management

Interest rate risk

The Group's objective is to manage its exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, including interest rate and cross-currency swaps.

The Group's interest rate management policy is that a minimum of 50% (2015 50%) and a maximum of 90% (2015 90%) of gross debt is maintained at fixed interest rates. At 31 December 2016, the Group had 81% (2015 83%) of fixed rate debt and 19% (2015 17%) of floating rate debt based on a gross debt of £4.3bn, including debt-related derivative financial assets (2015 £4.0bn).

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	Less than one year £m	Between one and two years £m	More than two years £m
Cash and cash equivalents	2,769	–	–
Loans and overdrafts	(811)	(811)	–

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2016, the Group had a total of $1.0bn (2015 $1.0bn) of this type of swap outstanding with a weighted average duration of 2.6 years (2015 3.6 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 11.6 years (2015 11.5 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 4.1% (2015 3.5%) on US dollars. The cost of the fixed rate debt was 4.8% (2015 4.9%).

A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £8m (2015 £7m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £14m (2015 £7m).

Liquidity risk

Contractual cash flows on financial liabilities

The contracted cash flows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash flows are shown on a gross basis, are not discounted and include estimated interest payments where applicable.

	31 December 2016					31 December 2015				
		Contracted cash flow					Contracted cash flow			
	Carrying amount £m	**Less than one year £m**	**Between one and five years £m**	**More than five years £m**	**Total £m**	Carrying amount £m	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
Loans and overdrafts	**(4,425)**	**(217)**	**(2,354)**	**(4,055)**	**(6,626)**	(4,012)	(431)	(1,698)	(3,939)	(6,068)
(Sale)/purchase contracts:										
US dollar		**(396)**	**23**	**30**	**(343)**		(299)	(217)	50	(466)
Euro		**466**	**225**	**18**	**709**		814	238	27	1,079
Sterling		**(333)**	**(307)**	**(55)**	**(695)**		(555)	(89)	(77)	(721)
Other		**255**	**58**	**7**	**320**		35	55	–	90
Cash flow hedges – foreign exchange contracts	**3**	**(8)**	**(1)**	**–**	**(9)**	(96)	(5)	(13)	–	(18)
Purchase/(sale) contracts:										
US dollar		**1,809**	**–**	**–**	**1,809**		2,133	(4)	–	2,129
Euro		**620**	**–**	**–**	**620**		441	–	–	441
Sterling		**(2,624)**	**–**	**–**	**(2,624)**		(2,672)	4	–	(2,668)
Other		**195**	**–**	**–**	**195**		98	–	–	98
Interest rate contracts		**7**	**106**	**–**	**113**		3	(1)	–	2
Other foreign exchange/interest rate contracts	**118**	**7**	**106**	**–**	**113**	53	3	(1)	–	2
Debt-related derivative financial instruments	**114**	**10**	**29**	**147**	**186**	53	6	11	55	72
Other financial assets and liabilities	**235**	**9**	**134**	**147**	**290**	10	4	(3)	55	56

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

26. Financial risk management continued

Borrowing facilities
The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2016, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2015 £2bn). The RCF is contracted until 2018 at £2bn and from 2018 to 2020 at £1.9bn. The RCF was undrawn throughout the year. The RCF also acts as a back stop to Commercial Paper issued by the Group. At 31 December 2016, the Group had no Commercial Paper in issue (2015 £nil).

Cash management
Cash flow forecasting is performed by the businesses on a monthly basis. The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet operational needs and maintain adequate headroom.

Surplus cash held by the businesses over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in instant-access current accounts, short-term deposits and money market funds, choosing instruments with appropriate maturities or sufficient liquidity to provide adequate headroom as determined by cash forecasts.

The Group's objective is to monitor and control counterparty credit risk and credit limit utilisation. The Group adopts a conservative approach to the investment of its surplus cash which is deposited with financial institutions with the strongest credit ratings for short periods. The cash and cash equivalents balance at 31 December 2016 of £2,769m (2015 £2,537m) was invested with 33 (2015 35) financial institutions. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price.

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid, such as short-term deposits. The Group, therefore, believes it has reduced its exposure to counterparty credit risk through this process.

Currency risk
The Group's objective is to reduce its exposure to transactional volatility in earnings and cash flows from movements in foreign currency exchange rates, mainly the US dollar, euro, Saudi riyal and Australian dollar.

The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. All material firm transactional exposures are hedged and the Group aims, where possible, to apply hedge accounting to these transactions.

The Group is exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.

The estimated impact on foreign exchange gains and losses in net finance costs of a ten cent movement in the closing US dollar exchange rate on the retranslation of US dollar-denominated bonds held by BAE Systems plc is approximately £59m (2015 £58m).

Credit risk
The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, a provision for bad debts has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk, and no one counterparty constitutes more than 11% of the balance (2015 12%).

The ageing of trade receivables is detailed below:

	2016			2015[1]		
	Gross £m	**Provision £m**	**Net £m**	Gross £m	Provision £m	Net £m
Not past due and not impaired	**850**	**–**	**850**	807	–	807
Up to 180 days overdue and not impaired	**466**	**–**	**466**	376	–	376
Past 180 days overdue and not impaired	**76**	**–**	**76**	59	–	59
Past 180 days overdue and impaired	**85**	**(40)**	**45**	76	(34)	42
	1,477	**(40)**	**1,437**	1,318	(34)	1,284

1. Restated.

Movements on the provision for bad debts are as follows:

	2016 £m	2015[1] £m
At 1 January	**34**	28
Created	**15**	17
Utilised	**(2)**	(3)
Released	**(13)**	(9)
Foreign exchange adjustments	**6**	1
At 31 December	**40**	34

1. Restated.

Notes to the Group accounts
continued

27. Share-based payments

The Group has granted equity-settled share options and Long-Term Incentive Plan arrangements which are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the number of shares that will actually vest.

Details of the terms and conditions of each share-based payment plan are given in the Annual remuneration report on pages 84 to 98.

Expense in year

	2016 £m	2015 £m
Executive Share Option Plan	**6**	6
Performance Share Plan	**11**	6
Restricted Share Plan	**5**	4
	22	16

The Group also incurred a charge of £33m (2015 £28m) in respect of the equity-settled all-employee Free Shares and Matching Partnership Shares elements of the Share Incentive Plan.

Executive Share Option Plan

	2016		2015	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**32,165**	**4.26**	35,594	3.70
Granted during the year	**10,981**	**5.02**	9,349	5.25
Exercised during the year	**(6,255)**	**3.81**	(9,838)	3.38
Expired during the year	**(2,576)**	**4.28**	(2,940)	3.52
Outstanding at the end of the year	**34,315**	**4.59**	32,165	4.26
Exercisable at the end of the year	**5,961**	**3.56**	4,307	3.30

	2016	2015
Range of exercise price of outstanding options (£)	**3.01 – 5.56**	3.01 – 5.43
Weighted average remaining contracted life (years)	**8**	8
Weighted average fair value of options granted (£)	**0.65**	0.76

27. Share-based payments continued

Performance Share Plan, Share Matching Plan and Restricted Share Plan

	Performance Share Plan		Share Matching Plan		Restricted Share Plan	
	2016 Number of shares '000	2015 Number of shares '000	**2016 Number of shares '000**	2015 Number of shares '000	**2016 Number of shares '000**	2015 Number of shares '000
Outstanding at the beginning of the year	**19,662**	18,868	**2,252**	5,618	**2,847**	3,760
Granted during the year	**8,638**	7,167	**–**	–	**1,393**	1,218
Exercised during the year	**(361)**	(335)	**–**	–	**(699)**	(1,876)
Expired during the year	**(4,947)**	(6,038)	**(2,252)**	(3,366)	**(213)**	(255)
Outstanding at the end of the year	**22,992**	19,662	**–**	2,252	**3,328**	2,847
Exercisable at the end of the year	**81**	204	**–**	–	**–**	–

	2016	2015	**2016**	2015	**2016**	2015
Weighted average remaining contracted life (years)	**5**	5	**–**	–	**5**	5
Weighted average fair value of awards granted (£)	**4.09**	4.49	**–**	–	**5.01**	5.12

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2015 £nil).

Details of options/awards granted in the year

The fair value of equity-settled options/awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

Executive Share Option Plan – Binomial
Performance Share Plan – Monte Carlo
Restricted Share Plan – Dividend valuation

	2016	2015
Range of share price at date of grant (£)	**4.99 – 5.56**	4.38 – 5.43
Expected option/award life (years)	**3 – 10**	3 – 10
Volatility (%)	**20**	20 – 21
Risk free interest rate (%)	**0.1 – 0.4**	0.5 – 0.9

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £5.24 (2015 £4.87).

Notes to the Group accounts continued

28. Related party transactions

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 11) and pension schemes (note 20).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party[1]		Management recharges[1]	
Related party	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m
Advanced Electronics Company Limited	**27**	22	**95**	46	**–**	–	**–**	–	**–**	–
CTA International SAS	**6**	15	**–**	–	**4**	11	**–**	–	**–**	–
Eurofighter Jagdflugzeug GmbH	**997**	1,417	**3**	–	**41**	37	**126**	65	**–**	–
FADEC International LLC	**79**	72	**–**	–	**–**	–	**–**	–	**–**	–
Gripen International KB	**–**	–	**–**	–	**18**	19	**16**	14	**–**	–
MBDA SAS[2]	**24**	23	**199**	286	**2**	6	**608**	367	**16**	17
Panavia Aircraft GmbH	**64**	53	**79**	47	**4**	2	**–**	–	**–**	–
	1,197	1,602	**376**	379	**69**	75	**750**	446	**16**	17

1. Also relates to disclosures under IAS 24, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2016, £631m (2015 £405m) was owed by BAE Systems plc and £119m (2015 £41m) by other Group subsidiaries.
2. Amounts owed to related party excludes £285m (2015 £217m) included within amounts due to long-term contract customers.

The Group considers key management personnel as defined under IAS 24, Related Party Disclosures, to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Annual remuneration report on pages 84 to 98. Total emoluments for directors and key management personnel charged to the Consolidated income statement were:

	2016 £'000	2015 £'000
Short-term employee benefits	**19,389**	14,831
Post-employment benefits	**1,931**	2,021
Share-based payments	**5,744**	4,144
	27,064	20,996

29. Contingent liabilities

Contingent liabilities are potential future cash outflows which are either not probable or cannot be measured reliably.

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business and regards these as insurance contracts. Various Group undertakings are parties to legal actions and claims which arise in the normal course of business. Provision is made for any amounts that the directors consider may become payable (see note 21).

The Group has no individually significant contingent liabilities.

30. Commitments

Operating lease commitments

The Group leases various offices, factories and shipyards under non-cancellable operating lease agreements. The leases have varying terms, including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2016 £m	2015 £m
Payments due:		
Not later than one year	**255**	222
Later than one year and not later than five years	**699**	710
Later than five years	**802**	779
	1,756	1,711
Total of future minimum sublease income under non-cancellable subleases	**115**	139

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2016 £m	2015 £m
Property, plant and equipment[1]	**429**	264
Intangible assets	**19**	8
	448	272

1. Includes £158m (2015 £99m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

Notes to the Group accounts
continued

31. Information about related undertakings

In accordance with Section 409 of the Companies Act 2006, a full list of subsidiaries and equity accounted investments as at 31 December 2016 is disclosed below. Unless otherwise stated, the Group's shareholding represents ordinary shares held indirectly by BAE Systems plc, the year end is 31 December and the address of the registered office is Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire GU14 6YU, United Kingdom. No subsidiary undertakings have been excluded from the consolidation.

Subsidiaries – wholly-owned

4219 Lafayette, LLC[22]
4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Aerosystems International Limited
Lupin Way, Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Alabama Dry Dock and Shipbuilding, LLC[22]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

Alvis Pension Scheme Trustees Limited

Alvis Limited

Alvis Vickers Limited

Armor Holdings Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

Armstrong Whitworth Aircraft Limited[1]

Atlantic-Alabama Holding Company, LLC[22]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

Australian Marine Engineering Corporation (Finance) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Avro International Aerospace Limited[1]

BAE Systems (Aberdeen) Limited[13,16]
Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EG, United Kingdom

BAE Systems (Al Diriyah C4i) Limited[1]

BAE Systems (Aviation Services) Limited

BAE Systems (Bristol House) Limited[1,11,16]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems (Canada) Inc.
220 Laurier Avenue West, Suite 1200, Ottawa ON K1P 5Z9, Canada

BAE Systems (Combat and Radar Systems) Limited
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

BAE Systems (Consultancy Services) Limited

BAE Systems (Corporate Air Travel) Limited

BAE Systems (CS&SI – Qatar) Limited[1]

BAE Systems (Defence Systems) Limited

BAE Systems (Dynamics) Limited

BAE Systems (Farnborough 1) Limited

BAE Systems (Farnborough 2) Limited

BAE Systems (Farnborough 3) Limited

BAE Systems (Finance) Limited

BAE Systems (Funding Three) Limited

BAE Systems (Funding Two) Limited

BAE Systems (Gripen Overseas) Limited

BAE Systems (Hawk Synthetic Training) Limited

BAE Systems (Holdings) Limited[1]

BAE Systems (Insurance) Limited

BAE Systems (International) Limited

BAE Systems (Kazakhstan) Limited

BAE Systems (Land and Sea Systems) Limited[11]

BAE Systems (Malaysia) Sdn Bhd
16th Floor, Wisma Sime Darby, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia

BAE Systems (MEH) Limited

BAE Systems (Military Air) Overseas Limited

BAE Systems (Moose Jaw) Inc.[1,5]
LeBlanc Nichols, The Chambers, 1000-300 Terry Fox Drive, Ottawa ON K2K 0E3, Canada

BAE Systems (Nominees) Limited[1]

BAE Systems (Oman) Limited

BAE Systems (Operations) Limited[10]

BAE Systems (Operations) Singapore Pte Limited
One Marina Boulevard #28-00, Singapore 018989, Singapore

BAE Systems (Overseas Holdings) Limited

BAE Systems (Poland) Sp. z o.o.
ul. Abp. A. Baraniaka 88, 61-131 Poznan, Poland

BAE Systems (Projects) Limited

BAE Systems (Property Investments) Limited

BAE Systems (Sweden) AB[17]
c/o Advokatfirman DLA Nordic KB, Box 7315, SE-103 90 Stockholm, Sweden

BAE Systems (Vehicles and Equipment) Limited

BAE Systems 2000 Pension Plan Trustees Limited[1]

BAE Systems AB[13]
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Al Diriyah Programme Limited[1]

BAE Systems Applied Intelligence (Asia Pacific) Pte Limited
United Square, 101 Thomson Road, #25-03/04, 307591, Singapore

BAE Systems Applied Intelligence (Australia) Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence (Belgium) NV
Geldenaaksebaan 329, B-3001, Heverlee, Leuven, Belgium

BAE Systems Applied Intelligence Canada Inc.
1959 Upper Water Street, Suite 900, Halifax NS B3J 2X2, Canada

BAE Systems Applied Intelligence (Connect) A/S
Bouet Mollevej 3-5, 9400 Norresundby, Denmark

BAE Systems Applied Intelligence Inc.[5]
5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States

BAE Systems Applied Intelligence GCS Inc.[6]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

BAE Systems Applied Intelligence (GCS) Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (Germany) GmbH
Mainzer Landstrasse 50, 60325 Frankfurt am Main, Germany

BAE Systems Applied Intelligence (Integration) Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (International) Limited
Priestley Road, Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (Ireland) Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

BAE Systems Applied Intelligence (Japan) KK
Ark Mori Building, Regus Serviced Office, Office #103, Akasaka, Minato-ku, Tokyo, Japan, 107-6012

BAE Systems Applied Intelligence (Luxembourg) SARL
1 Boulevard de la Foire, L-1528 Luxembourg, Luxembourg

BAE Systems Applied Intelligence (Spain) S.A.
Paseo de la Castellana, 141, Cuzco IV, 28046 Madrid, Spain

BAE Systems Applied Intelligence (UK) Limited

BAE Systems Applied Intelligence A/S
Bouet Mollevej 3, 9400 Norresundby, Denmark

BAE Systems Applied Intelligence France SAS
112 Avenue Kleber, 75016, Paris, France

BAE Systems Applied Intelligence Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence LLC[22]
8200 Greensboro Drive, 9th Floor, McLean VA 22102, United States

BAE Systems Applied Intelligence Malaysia Sdn Bhd
16th Floor, Wisma Sime Darby, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia

BAE Systems Applied Intelligence New Zealand Limited
c/o Russell McVeagh, Vero Centre, 48 Shortland Street, Auckland Central, 1140, New Zealand

BAE Systems Applied Intelligence Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence US Corp[6]
440 Wheelers Farms Road, Suite 202, Milford CT 06461, United States

BAE Systems Australia Datagate Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Pty Limited[14]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Electronic Systems) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Singapore) Pte Limited[20]
60 Paya Lebar Road, #08-43 Paya Lebar Square, 409051, Singapore

BAE Systems Australia Holdings Limited[1]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Logistics Pty Limited[10]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Sea Sentinel Project Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Avionics Singapore Pte Limited
One Marina Boulevard, #28-00, Singapore 018989, Singapore

BAE Systems Bofors AB
SE-691 80 Karlskoga, Sweden

BAE Systems Bofors Holdings Sdn Bhd
Level 21, Suite 21.01, The Gardens South Tower, Mid Valley City, Lingkaran Syed Putra, 59200 Kuala Lumpur, Malaysia

BAE Systems China (Exports) Limited

BAE Systems C-ITS AB
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Command and Control Limited[10,16]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Communications Limited[1]

BAE Systems Communications Solutions, LLC[22]
Knowledge Oasis, Building 4, Second Floor, 0402-Z427, Knowledge Oasis Muscat, PO Box 16, Postal Code 135, Muscat, Oman

BAE Systems Controls Inc.[5]
1098 Clark Street, Endicott NY 13760, United States

BAE Systems Creole Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Datagate Limited

BAE Systems Datagate Holdings Limited

BAE Systems Defence Limited[1]

BAE Systems Deployed Systems Limited[2]

31. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Display Technologies Limited

BAE Systems do Brasil Ltda
SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil

BAE Systems Electronic Systems (Overseas) Limited

BAE Systems Electronics Limited

BAE Systems Enterprises Limited

BAE Systems Executive Pension Scheme Trustees Limited[1]

BAE Systems Finance (Ireland) Unlimited Company[23]
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

BAE Systems Finance B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Finance Inc.[6]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Flight Training (Australia) Pty Limited[10]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Funds Management[1,23]

BAE Systems Global Combat Systems Bridging Limited

BAE Systems Global Combat Systems Limited

BAE Systems Global Combat Systems Munitions Limited

BAE Systems Global Mobility LLC[22]
1300 Wilson Blvd., Arlington VA 22209, United States

BAE Systems Global Tactical Systems LLC[22]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Hägglunds AB
SE-691 80, Karlskoga, Sweden

BAE Systems Hawaii Shipyards Inc.[6]
3049 Ualena Street, Suite 915, Honolulu HI 96819, United States

BAE Systems Holdings (South Africa) (Pty) Limited
Central Office Park No. 5, 257 Jean Avenue, Centurion, Gauteng, 0157, South Africa

BAE Systems Holdings B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Holding GmbH[17]
Hauptstrasse 48, 82433 Bad Kohlgrub, Germany

BAE Systems Holdings Inc.[5]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Holdings International LLC[22]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Imaging Solutions Inc.[5]
1841 Zanker Road, Suite 50, San Jose CA 95112, United States

BAE Systems, Inc.[6]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems India (Services) Private Limited[18]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Homeland Security) Private Limited[18]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Technology) Private Limited[18]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Ventures) Private Limited[18]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems Information and Electronic Systems Integration Inc.[6]
65 Spit Brook Road, Nashua NH 03061, United States

BAE Systems Insurance (Isle of Man) Limited
Tower House, Loch Promenade, Douglas, IM1 2LZ, Isle of Man, United Kingdom

BAE Systems Insyte Limited[16]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Integrated System Technologies (KSA) Limited

BAE Systems Integrated System Technologies (Overseas) Limited

BAE Systems Integrated System Technologies GmbH
Hans-Stießberger-Str. 2b, 85540 Haar, Germany

BAE Systems Integrated System Technologies Limited

BAE Systems International Inc.[5]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Land & Armaments Holdings Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments L.P.[22]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land Systems ATF Limited

BAE Systems Land Systems (Finance) Limited

BAE Systems Land Systems FMTV International Inc.[7]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Land Systems (Investments AVG) Limited[16]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Land Systems (Investments South Africa) Limited

BAE Systems Land Systems (Investments) Limited

BAE Systems Land Systems (Logistics) Limited

BAE Systems Land Systems Pinzgauer Limited

BAE Systems Land Systems Pinzgauer (Holdings) Limited

BAE Systems Land Systems (Ranges) Limited

BAE Systems Land Systems (Singapore Investments) Limited

BAE Systems Logistica Ltda
SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil

BAE Systems MAI Turkey Hava Sistemleri A.Ş
Kizilimak Mahallesi, 1445. Sok No: 2, The Paragon B Blok K: 23, iç Kapi No: 113 Çukurambar, Çankaya, Ankara, Turkey

BAE Systems Marine (Holdings) Limited

BAE Systems Marine (YSL) Limited

BAE Systems Marine Limited

BAE Systems Maritime Engineering & Services Inc.[6]
7330 Engineer Road, Suite A, San Diego CA 92111, United States

BAE Systems Norfolk Ship Repair Inc.[6]
750 West Berkley Avenue, Norfolk VA 23523, United States

BAE Systems Oman LLC[22]
PO Box 74, Postal Code 111, Seeb, Oman

BAE Systems Ordnance Systems Inc.[6]
4509 West Stone Drive, Kingsport TN 37660-9982, United States

BAE Systems Overseas Inc.[6]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems PAMCO Services International Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Pension Funds CIF Trustees Limited[1]

BAE Systems Pension Funds Investment Management Limited[1,19]

BAE Systems Pension Funds Trustees Limited[1]

BAE Systems Project Services Limited

BAE Systems Projects (Canada) Limited

BAE Systems Properties Limited

BAE Systems Protection Systems Inc.[7]
7822 South 46th Street, Phoenix AZ 85044, United States

BAE Systems Quest Limited[1]

BAE Systems Regional Aircraft (Japan) KK[6]
Minami Azabu T&F Building 8th Floor, 4-11-22 Minami Azabu, Minato-ku, Tokyo, Japan

BAE Systems Regional Aircraft Colombia SAS
c/o Brigard & Urrutia, Calle 70 A No. 4-41, Bogota, Colombia

BAE Systems Resolution Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems RO Defense Inc.[6]
1801 Electronics Drive, Anniston AL 36207, United States

BAE Systems Rokar International Limited
PO Box 45059, 11 Hartom Street, Mount Hotzvim, 91450 Jerusalem, Israel

BAE Systems S&S Holdings Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems S&S Operations Inc.[6]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems San Diego Ship Repair Inc.[6]
2205 East Belt Street, Foot of Sampson Street, San Diego CA 92113, United States

BAE Systems San Francisco Ship Repair Inc.[6]
Foot of 20th Street at Illinois Street, San Francisco CA 94107-7644, United States

BAE Systems Saudi Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

BAE Systems Saudi Arabia (Maintenance and Equipment Services) Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

BAE Systems Saudi Arabia (Vehicles and Equipment Holdings) Limited[1]

BAE Systems Saudi Arabia (Vehicles and Equipment Nominees) Limited[1]

BAE Systems Serviços de Aviônicos Ltda.
Rua Boa Vista, No. 254, 13th Floor, Suite 15, Centro, São Paulo, São Paulo 01014-907, Brazil

BAE Systems Shared Services Inc.[6]
11215 Rushmore Drive, Charlotte NC 28277, United States

BAE Systems Shared Services (Overseas) Limited

BAE Systems Share Plans Trustee Limited[1]

BAE Systems Ship Repair Inc.[6]
750 West Berkley Ave., Norfolk VA 23523, United States

BAE Systems Southeast Shipyards Alabama LLC[22]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

BAE Systems Southeast Shipyards AMHC Inc.[6,22]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Southeast Shipyards Jacksonville LLC[22]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Southeast Shipyards Mayport LLC[22]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems SSY Alabama Property Holdings LLC[22]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

BAE Systems SSY Floating Dry Dock Holdings LLC[22]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems SSY Florida Property Holdings LLC[22]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Surface Ships (Holdings) Limited

BAE Systems Surface Ships Limited

BAE Systems Surface Ships (Projects) Limited

BAE Systems Surface Ships Intermediate Holdings Limited

BAE Systems Surface Ships Integrated Support Limited

BAE Systems Surface Ships International Limited[13]

BAE Systems Surface Ships Maritime Limited

BAE Systems Surface Ships Portsmouth Limited[13]

BAE Systems Surface Ships Projects (Malaysia) Sdn Bhd
Level 14, West Block, Wisma Selangor Dredging, 142-C, Jalan Ampang, 50450 Kuala Lumpur, Malaysia

BAE Systems Surface Ships Property Services Limited

BAE Systems Surface Ships Support Limited[10]

BAE Systems Surface Ships (Overseas) Limited

BAE Systems SWS Defence AB
SE-691 80 Karlskoga, Sweden

BAE Systems Tactical Vehicle Systems LP[22]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

Notes to the Group accounts continued

31. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Technology Solutions & Services Inc.[6]
520 Gaither Road, Rockville, MD 20850, United States

BAE Systems Training Services Limited

BAE Systems TVS Holdings Inc.[6]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Holdings LLC[22]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Zephyr Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Fifth Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Fourth Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Second Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Third Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

Brabazon Limited

British Aerospace (Far East) Limited[21]
Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong

British Aerospace (Malaysia) Sdn Bhd[21]
Unit 30-01, Level 30, Tower A, Vertical Business Suite, Avenue 3, Bangsar South, No.8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia

British Aircraft Corporation (Pension Fund Trustees) Limited[1]

British Aircraft Corporation Limited[1]

Buckfield Properties Limited

Cashhold Limited[1,10]

CPS International, Inc.[7]
c/o Benedetti & Benedetti, Comosa Building, 21st Floor, Ave. Samuel Lewis, PO Box 850120, Panama 5, Panama

Creole (Nigeria) Limited[10]
Tapa House (2nd Floor), 45, Imman Dauda St (Abosede Kuboye Crescent Entrance) Surulere, Lagos, Nigeria

Detica B.V.
Luna ArenA, Herikerbergweg 238, 1101 CM Amsterdam, Netherlands

Detica Group Holdings (Ireland) Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Group Limited

Detica Ireland Limited[13]
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Mexico S. de R.L. de C.V.
Torre Esmeralda II, Blvd Manuel Avila Camacho No. 36 Piso 18, Lomas de Chapultepec, 11000 D.F., Mexico

Detica Patent Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Services, Inc.
8200 Greensboro Drive, 9th Floor, McLean VA 22102, United States

ETI Engineering, Inc.[6]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

Gloster Aircraft Limited[1]

Granada Enterprises Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

Hadrian Trustees Limited[1,18]
2nd floor, Viables 3, Viables Business Park, Jays Close, Basingstoke, Hampshire RG22 4BS, United Kingdom

Hadrian Holdings, Inc.[18]
521 Fifth Avenue, New York NY 101075, United States

Hägglunds Vehicle GmbH
Ernst-Grote Strasse 13, 30916 Isernhagen, Germany

Hawker Siddeley Aviation Limited[1]

Hawker Siddeley Dynamics Limited[1]

H-B Utveckling, H-B Development AB
Nybrogatan 7, SE-114 34 Stockholm, Sweden

Hertfordshire Estates Limited[10]

HSA/HSD Pension Fund Trustees Limited[1]

Hunter Aerospace Corporation Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

International Military Sales Limited

Jetstream Aircraft Limited[1]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Kalamind Limited

Land Services Arabia Ltd.
Business Gate Building 7, Floor 1, Riyadh 11482, Saudi Arabia

Lemacrown Limited[12]

MES Holdco Limited
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

MES Interco[23]

Meslink Limited

Muiden Chemie International B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Newcombe Properties Limited

PAMCO Servicios Internationales de Mexico, S. de R.L. de C.V.[7]
c/o Gonzalez Calvillo y Forastieri, S.C., Centro Empresarial Lomas, Monte Peloux No. 111, Piso 5, Lomas de Chapultepec, 11000 D.F., Mexico

Piper Group plc

Pitch Technologies AB
Repslagaregatan 25, SE-582 22 Linköping, Sweden

Pitch Technologies Limited
Sweden House, 5 Upper Montagu Street, London W1H 2AG, United Kingdom

Port Solent Limited

Port Solent Marina Limited

PT. BAE Systems Services[6]
Wisma 46, Kota BNI, 34th Floor, Suite 34.01.A, Jl. Jenderal Sudirman Kavling 71, Jakarta 10220, Indonesia

Reflectone UK Limited[16]
15 Canada Square, London E14 5GL, United Kingdom

Representaciones SSTS, CA[7]
Ave Francisco de Miranda, Centro Lido El Rosal Oficina 71B, Caracas, Venezuela

Royal Ordnance B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Royal Ordnance (Crown Service) Pension Scheme Trustees Limited

Royal Ordnance Maschinen und Anlagenbau Gmbh[17]
Heckler & Koch Straße 1, D-78727 Oberndorf a.N, Germany

Royal Ordnance Senior Staff Pension Scheme Trustees Limited

Royal Ordnance Speciality Metals Limited[1]

RWT Limited[1]

Salford Electrical Instruments Limited

Scentcivil Limited

Scottish Aviation Limited[1]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Sepia, LLC[22]
4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Shipbuilding (MSF) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Shipbuilding (VIC) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Stephen Howe Systems Limited
Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Stewart & Stevenson Operations (Nigeria) Limited[7]
Tapa House (2nd Floor), 45, Imman Dauda St (Abosede Kuboye Crescent Entrance), Surulere, Lagos, Nigeria

Stewart & Stevenson TVS UK Limited

Stratsec.net Sdn Bhd
Unit F-3-1, Blok F, Third Floor, CBD Perdana 3, Jalan Perdana, Cyber 12, 63000 Cyberjaya, Selangor Darul Ehsan, Malaysia

Support Solutions General Services and Contracting Company/Limited Liability company[17,22]
House No. 145, Street No. 1, Qtr. 611, Al Andulous Area, Al Mansour, Baghdad, Iraq

TDS International Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

TDS International Holdings Pty Limited[8]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Tenix Philippines Inc.[17,20]
1605 Tower One, Ayala Triangle, Ayala Avenue, Makati City, 1226, Philippines

The Blackburn Aeroplane & Motor Co Limited[1]

The Bristol Aviation Company Limited[1]

The British & Colonial Aeroplane Co. Limited[1]

The Leeds Partnership Limited[10]

The Supermarine Aviation Works Limited[1,11]

Thomas Sopwith Aviation Company Limited[1]

VSEL Birkenhead Limited

Warship Design Services Limited

Westover Controls Incorporated[6]
1098 Clark Street, Endicott NY 13760, United States

31. Information about related undertakings continued

Subsidiaries – not wholly-owned

Aircraft Accessories & Components Co Limited (85.7%)
PO Box 13532, Jeddah 21434, Saudi Arabia

Aircraft Research Association Limited (87.1%)[1]
Manton Lane, Bedford MK41 7PF, United Kingdom

ARA Pension Fund Trustees Limited (87.1%)
Manton Lane, Bedford MK41 7PF, United Kingdom

BAE Systems Saudi Development and Training Company Limited (99%)[3]
PO Box 67775, Riyadh 11517, Saudi Arabia

BAE Systems SDT (UK) Limited (99%)

Flight Control System Management GmbH (66.6%)[4]
PO Box 801109, 81663 Munich, Germany

Hadrian Properties, Inc. (95%)[18]
521 Fifth Avenue, New York NY 101075, United States

Hägglunds Foremost Inc. (66.7%)[5]
1616 Meridian Road N.E., Calgary AB T2A 2PL, Canada

International Systems Engineering Company Limited (90.6%)
PO Box 54002, Riyadh 11514, Saudi Arabia

Overhaul and Maintenance Company Limited (95.9%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Maintenance & Supply Chain Management Company Limited (51%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Technology & Logistics Services Limited (65%)[1]
PO Box 1732, Riyadh 11441, Saudi Arabia

SMSCMC (UK) Limited (51%)

U.S. Munitions, LLC (51%)[22]
1713 Burdette Crossing, Blue Springs MO 64015, United States

Equity accounted investments[24]

Abercromby Property International (21.5%)

Advanced Electronics Company Limited (50%)
PO Box 90916, Riyadh 11623, Saudi Arabia

Air Astana (49%)[5]
Zakarpatskaya Str 4A, 050039 Almaty, Kazakhstan

AMSH B.V. (50%)[9]
Weena 210-212, 3012 NJ Rotterdam, Netherlands

BAeHAL Software Limited (40%)[1,18]
Airport Lane, HAL Estate, Bangalore 560010, India

BHIC Bofors Defense Asia Sdn Bhd (49%)
Suite B, Menara Maxis, Kuala Lumpur City Centre, 50088 Kuala Lumpur, Malaysia

BAE (Consultancy Services) Malaysia Sdn Bhd (49%)
Tkt.11, Wisma Damansara, Damansara Heights, 50490 Kuala Lumpur, Malaysia

Canadian Naval Support Limited (50%)[15]
3099 Barrington Street, Halifax NS B3K 5M7, Canada

CTA International SAS (50%)
13 Route De La Miniere, 78000 Versailles, France

Data Link Solutions L.L.C. (50%)[21,22]
400 Collins Ave, Cedar Rapids IA 52498, United States

Eurofighter Aircraft Management GmbH (33%)[1,17]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Eurofighter International Limited (33%)[1,9,17]

Eurofighter Jagdflugzeug GmbH (33%)[1]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

European Aerosystems Limited (50%)[1,8]

FADEC International LLC (50%)[22]
1098 Clark Street, Endicott NY 13760, United States

FAST Holdings Limited (50%)[8,18]

FAST Training Services Limited (50%)[18]

FBV Designs Limited (50%)[8,18]
33 Wigmore Street, London W1U 1QX, United Kingdom

FNSS Savunma Sistemleri A.S (49%)[8]
PK 37, Golbasi 06830, Ankara, Turkey

Gripen International KB (50%)[22]
SE-581 88 Linköping, Sweden

MBDA Holdings SAS (25%)
1 Avenue Réaumur, 92350 Le Plessis-Robinson, France

Nobeli Business Support AB (34%)
SE-691 80 Karlskoga, Sweden

Nurol BAE Systems Hava Sistemleri Anonim Şirketi (49%)[9]
Arjantin Cad. No: 7 06700, Gaziosmanpaşa, Ankara, Turkey

Panavia Aircraft GmbH (42.5%)[1]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Patria Hägglunds Oy (50%)
Naulakatu 3, FI -33100 Tampere, Finland

Reaction Engines Limited (20%)[9]
Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom

Saab-BAe Systems Gripen AB (50%)[1]
SE-581 88 Linköping, Sweden

Saab Bofors Test Center AB (30%)
SE-691 80 Karlskoga, Sweden

Sandstone Integrated Operations, LLC (20%)[22]
2016 Mt. Athos Road, Lynchburg VA 24504, United States

Seele-Alvis Fenestration Limited (43.5%)[8,20]
Unit A33, Jack's Place, 6 Corbett Place, London E1 6NN, United Kingdom

SIKA International Limited (50%)[8]

Spectrum Technologies Public Limited Company (20%)[1,18]
Western Avenue, Bridgend Industrial Estate, Bridgend, Mid Glamorgan CF31 3RT, United Kingdom

Tirs Mateen & Co LLC (50%)[22]
PO Box 3369, Postal Code 111, Seeb, Oman

Winner Developments Limited (33.3%)

Notes

1. Directly owned by BAE Systems plc.
2. 40% owned by BAE Systems plc.
3. 1% owned by BAE Systems plc.
4. 33.3% owned by BAE Systems plc.
5. Ownership held in common stock.
6. Ownership held in common shares.
7. Ownership held in authorized shares.
8. Ownership held in class of A shares.
9. Ownership held in class of B shares.
10. Ownership held in class of A shares and B shares.
11. Ownership held in class of A shares, B shares and preference shares.
12. Ownership held in ordinary shares and class of A shares.
13. Ownership held in ordinary shares and preference shares.
14. Ownership held in ordinary shares and redeemable preference shares.
15. Ownership held in common shares and B Preferred shares.
16. In members' voluntary liquidation.
17. In liquidation.
18. Year end 31 March.
19. Year end 5 April.
20. Year end 30 June.
21. Year end 30 September.
22. Unincorporated entity for which the address given is the principal place of business.
23. Unlimited company.
24. For companies incorporated outside of the United Kingdom, the country of incorporation is shown in the address.

Company statement of comprehensive income
for the year ended 31 December

	2016 £m	2015 £m
Profit for the year	**560**	94
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Remeasurements on retirement benefit schemes	**(56)**	14
Items that may be reclassified to the income statement:		
Amounts (charged)/credited to hedging reserve	**(13)**	7
Total other comprehensive income for the year (net of tax)	**(69)**	21
Total comprehensive income for the year	**491**	115

Company statement of changes in equity
for the year ended 31 December

	Issued share capital £m	Share premium £m	Other reserves £m	Retained earnings[1] £m	Total equity £m
At 1 January 2015	87	1,249	278	2,429	4,043
Profit for the year	–	–	–	94	94
Total other comprehensive income for the year	–	–	7	14	21
Share-based payments	–	–	–	39	39
Net sale of own shares	–	–	–	1	1
Ordinary share dividends	–	–	–	(655)	(655)
Non-distributable reserve transfer	–	–	(67)	67	–
At 31 December 2015	87	1,249	218	1,989	3,543
Profit for the year	–	–	–	560	560
Total other comprehensive income for the year	–	–	(13)	(56)	(69)
Share-based payments	–	–	–	50	50
Net sale of own shares	–	–	–	3	3
Ordinary share dividends	–	–	–	(670)	(670)
At 31 December 2016	**87**	**1,249**	**205**	**1,876**	**3,417**

1. The non-distributable portion of retained earnings is £354m (2015 restated £343m).

Company balance sheet
as at 31 December

	Notes	2016 £m	2015 £m
Non-current assets			
Intangible assets		**34**	31
Property, plant and equipment		**31**	20
Investments in subsidiary undertakings and participating interests	2	**8,149**	8,138
Other receivables		**4**	5
Retirement benefit surpluses	8	**8**	6
Other financial assets	4	**385**	151
		8,611	8,351
Current assets			
Trade and other receivables	3	**3,038**	3,221
Current tax		**14**	14
Other financial assets	4	**347**	212
Cash and cash equivalents		**2,168**	2,061
		5,567	5,508
Total assets		**14,178**	13,859
Non-current liabilities			
Loans	5	**(1,122)**	(1,005)
Other payables		**(33)**	(5)
Retirement benefit obligations	8	**(308)**	(259)
Other financial liabilities	4	**(182)**	(98)
Provisions	7	**(97)**	(105)
		(1,742)	(1,472)
Current liabilities			
Loans and overdrafts	5	**–**	(237)
Trade and other payables	6	**(8,664)**	(8,430)
Other financial liabilities	4	**(332)**	(165)
Provisions	7	**(23)**	(12)
		(9,019)	(8,844)
Total liabilities		**(10,761)**	(10,316)
Net assets		**3,417**	3,543
Capital and reserves			
Issued share capital		**87**	87
Share premium		**1,249**	1,249
Other reserves	9	**205**	218
Retained earnings		**1,876**	1,989
Total equity		**3,417**	3,543

Approved by the Board on 22 February 2017 and signed on its behalf by:

I G King
Chief Executive

P J Lynas
Group Finance Director

Registered number: 1470151

Notes to the Company accounts

1. Preparation

Basis of preparation

These financial statements were prepared in accordance with Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework. Amendments to FRS 101 (2014/15 cycle and other minor amendments), issued in July 2015, and Amendments to FRS 101 (2015/16 cycle), issued in July 2016, both effective for periods beginning on or after 1 January 2016, have been applied.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (IFRS) as adopted by the EU (EU-adopted IFRS), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken:

- the requirements of paragraphs 45(b) and 46 to 52 of IFRS 2, Share-based Payment;
- the requirements of paragraphs 62, B64(d), B64(e), B64(g), B64(h), B64(j), to B64(m), B64(n)(ii), B64(o)(ii), B64(p), B64(q)(ii), B66 and B67 of IFRS 3, Business Combinations;
- the requirements of paragraph 33(c) of IFRS 5, Non-current Assets Held for Sale and Discontinued Operations;
- the requirements of IFRS 7, Financial Instruments: Disclosures;
- the requirements of paragraphs 91 to 99 of IFRS 13, Fair Value Measurement;
- the requirement in paragraph 38 of IAS 1, Presentation of Financial Statements, to present comparative information in respect of: paragraph 79(a)(iv) of IAS 1; paragraph 73(e) of IAS 16, Property, Plant and Equipment; paragraph 118(e) of IAS 38, Intangible Assets; and paragraphs 76 and 79(d) of IAS 40, Investment Property;
- the requirements of paragraphs 10(d), 10(f), 16, 38A, 38B, 38C, 38D, 40A, 40B, 40C, 40D, 111 and 134 to 136 of IAS 1, Presentation of Financial Statements;
- the requirements of IAS 7, Statement of Cash Flows;
- the requirements of paragraphs 30 and 31 of IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors;
- the requirements of paragraphs 17 and 18A of IAS 24, Related Party Disclosures;
- the requirements in IAS 24, Related Party Disclosures, to disclose related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member; and
- the requirements of paragraphs 130(f)(ii), 130(f)(iii), 134(d) to 134(f) and 135(c) to 135(e) of IAS 36, Impairment of Assets.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

In accordance with Section 408(3) of the Companies Act 2006, the Company is exempt from the requirement to present its own income statement. The amount of profit for the year of the Company is disclosed in the Company statement of comprehensive income.

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of relevant financial assets and financial liabilities (including derivative instruments).

Significant accounting policies

The significant accounting policies applied in the preparation of these individual financial statements are set out below. These policies have been applied consistently to all the years presented, unless otherwise stated.

Investments in subsidiary undertakings and participating interests

Fixed asset investments in shares in subsidiary undertakings and participating interests are stated at cost less provision for impairment.

Other significant accounting policies

Other significant accounting policies are consistent with the Group accounts and the table below references where they are disclosed.

Significant accounting policy	Page
Loans and overdrafts	153
Retirement benefits	155
Provisions	164

2. Investments in subsidiary undertakings and participating interests

	£m
Cost	
At 1 January 2016	8,152
Additions	11
At 31 December 2016	**8,163**
Impairment provisions	
At 1 January and 31 December 2016	**14**
Net carrying value	
At 31 December 2016	**8,149**
At 31 December 2015	8,138

3. Trade and other receivables

	2016 £m	2015 £m
Current		
Amounts owed by subsidiary undertakings	**2,954**	3,159
Amounts owed by Group joint ventures	**–**	5
Prepayments and accrued income	**37**	45
Other receivables	**47**	12
	3,038	3,221

4. Other financial assets and liabilities

	2016		2015	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**1**	**–**	8	–
Other foreign exchange/interest rate contracts	**274**	**(182)**	97	(98)
Debt-related derivative financial instruments – assets	**110**	**–**	46	–
	385	**(182)**	151	(98)
Current				
Cash flow hedges – foreign exchange contracts	**1**	**(2)**	5	–
Other foreign exchange/interest rate contracts	**346**	**(330)**	207	(165)
	347	**(332)**	212	(165)

The contractual cash flows on derivative financial instruments at the reporting date are shown below, classified by maturity.

	2016 £m	2015 £m
Less than one year	**11**	2
Between one and five years	**136**	9
More than five years	**147**	55
	294	66

Full disclosures relating to the Group's other financial assets and liabilities, and financial risk management strategies are given in notes 13, 25 and 26 to the Group accounts.

Notes to the Company accounts continued

5. Loans and overdrafts

	2016 £m	2015 £m
Non-current		
US$500m 4.75% bond, repayable 2021	**404**	339
£400m 4.125% bond, repayable 2022	**398**	398
US$400m 5.8% bond, repayable 2041	**320**	268
	1,122	1,005
Current		
US$350m 3.5% bond, repayable 2016	**–**	237
	–	237

6. Trade and other payables

	2016 £m	2015 £m
Current		
Amounts owed to subsidiary undertakings	**7,830**	7,824
Amounts owed to Group joint ventures	**631**	405
Accruals and deferred income	**121**	100
Other payables	**82**	101
	8,664	8,430

7. Provisions

	Contracts and other £m
Non-current	105
Current	12
At 1 January 2016	117
Created	14
Utilised	(16)
Net present value adjustments	5
At 31 December 2016	**120**
Represented by:	
Non-current	97
Current	23
	120

The Company holds provisions for contractual costs that it expects to incur over an extended period. These costs are based on past experience of similar items and represent management's best estimate of the likely outcome.

8. Retirement benefits

The Company participates in all of the Group's UK pension schemes. Regular contributions to the schemes are made in line with the schedule of contributions and a share of deficit funding is allocated to participating employers. The deficit allocation methodology is based on the relative payroll contributions of active members. Full disclosures relating to these schemes are given in note 20 to the Group accounts.

Amounts recognised on the balance sheet

The table below shows the Company's share of the Group's UK pension schemes after allocation to other participating employers.

	2016 £m	2015 £m
Present value of unfunded obligations	**(39)**	(41)
Present value of funded obligations	**(1,429)**	(1,302)
Fair value of scheme assets	**1,168**	1,090
Company's share of net IAS 19 deficit	**(300)**	(253)
Represented by:		
Retirement benefit surpluses	**8**	6
Retirement benefit obligations	**(308)**	(259)
	(300)	(253)

9. Share capital and other reserves

Share capital

Disclosures in respect of the Company's share capital are provided in note 22 to the Group accounts.

Other reserves

	Non-distributable reserve £m	Statutory reserve £m	Capital redemption reserve £m	Hedging reserve £m	Total £m
At 1 January 2015	67	202	3	6	278
Amounts credited to hedging reserve	–	–	–	7	7
Transfer to retained earnings	(67)	–	–	–	(67)
At 31 December 2015	–	202	3	13	218
Amounts charged to hedging reserve	–	–	–	(13)	(13)
At 31 December 2016	**–**	**202**	**3**	**–**	**205**

Statutory reserve

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

Capital redemption reserve

The capital redemption reserve represents the cumulative nominal value of the Company's ordinary shares repurchased and subsequently cancelled.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Notes to the Company accounts
continued

10. Share-based payments

Options over shares of the Company have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Annual remuneration report on pages 84 to 98.

	2016		2015	
	Range of exercise price of outstanding options £	**Weighted average remaining contracted life Years**	Range of exercise price of outstanding options £	Weighted average remaining contracted life Years
Executive Share Option Plan	**3.01 – 5.56**	**8**	3.01 – 5.43	8
Performance Share Plan	**–**	**5**	–	5
Restricted Share Plan	**–**	**–**	–	5

The average share price in the year was £5.24 (2015 £4.87).

11. Other information

Company audit fee
Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,776,000 (2015 £1,759,000).

Employees
The total number of employees of the Company at 31 December 2016 was 1,101 (2015 1,030). Total staff costs, excluding charges for share-based payments, were £115m (2015 £98m).

Related party transactions
Disclosures in respect of related party transactions are provided in note 28 to the Group accounts.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

Directors' emoluments
Under Schedule 5 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (Schedule 5), total directors' emoluments, excluding Company pension contributions, were £10,806,172 (2015 £6,949,237); these amounts are calculated on a different basis to emoluments in the Annual remuneration report which are calculated under Schedule 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (Schedule 8 (2013)). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company. Under Schedule 5, the aggregate gains made by the directors from the exercise of share options in 2016 as at the date of exercise was £158,125 (2015 £992,252) and the net aggregate value of assets received by directors in 2016 from Long-Term Incentive Plans as calculated at the date of vesting was £nil (2015 £nil); these amounts are calculated on a different basis from the valuation of share plan benefits under Schedule 8 (2013) in the Annual remuneration report. Retirement benefits are accruing to two directors in respect of defined benefit schemes and to two directors in respect of defined contribution schemes.

Company guaranteed borrowings
Borrowings by subsidiary undertakings totalling £3,295m (2015 £2,764m), which are included in the Group's borrowings, have been guaranteed by the Company.

Information about related undertakings
In accordance with Section 409 of the Companies Act 2006, a full list of the Company's subsidiaries and significant holdings is included in note 31 to the Group accounts.

Shareholder information

Registered office
6 Carlton Gardens
London
SW1Y 5AD
United Kingdom

Telephone: +44 (0)1252 373232

Company website: **baesystems.com**

Registered in England and Wales, No. 1470151

Registrars
Equiniti Limited (0140)
Aspect House
Spencer Road
Lancing
West Sussex
BN99 6DA
United Kingdom

If you have any queries regarding your shareholding or need to notify any changes to your personal details, please contact Equiniti.

Equiniti's website (**help.shareview.co.uk**) includes a comprehensive set of answers to many frequently asked questions relating to managing a shareholding. If you cannot find the answer to your question, there is an online e-mail form, which will help to ensure your question is directed to the most appropriate team for a response. Alternatively, you can call the BAE Systems Helpline on 0371 384 2044 or, from outside the UK, +44 121 415 7058. Lines are open from 8.30am to 5.30pm Monday to Friday, excluding UK Bank holidays.

In addition, the following services are offered to shareholders:

– **Shareview** – online access to your shareholding, including balance movements, indicative share prices and information on recent payments
– **Dividend mandates** – have your dividends paid directly into either your UK bank/building society account or an overseas bank account
– **Dividend reinvestment plan (DRIP)** – have your dividend reinvested in shares purchased on the stock market

More information on all these services can be found on Equiniti's website (**shareview.co.uk**).

American Depositary Receipts
BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depositary. If you should have any queries, please contact:

JPMorgan Chase & Co
PO Box 64504
St Paul
MN 55164-0854 USA

Email: **jpmorgan.adr@wellsfargo.com**

Telephone number for general queries: (800) 990 1135

Telephone number from outside the US: +1 651 453 2128

ShareGift
ShareGift, the share donation charity (registered charity number 1052686), accepts donations of small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at **sharegift.org**, by telephone on 020 7930 3737 or by e-mail: **help@sharegift.org**

Share price information
The middle market price of the Company's ordinary shares on 31 December 2016 was 591.5p and the range during the year was 459.7p to 612.0p.

For more information
Visit the Shareholder information section of our website: **investors.baesystems.com**

FINANCIAL CALENDAR	
Financial year end	31 December
Annual General Meeting	10 May 2017
2016 final ordinary dividend payable	1 June 2017
2017 half-yearly results announcement	2 August 2017
2017 interim ordinary dividend payable	30 November 2017
2017 full-year results: – preliminary announcement – Annual Report	 February 2018 March 2018
2017 final ordinary dividend payable	June 2018

BEWARE OF SHARE FRAUD

Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment.

While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

Victims of share fraud lose an average of £20,000 to these scams, with as much as £200m being lost in the UK each year.

How to avoid share fraud

1. Keep in mind that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services Register from **fca.org.uk** to see if the person and firm contacting you is authorised by the FCA.
4. Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
5. Use the firm's contact details listed on the Register if you want to call it back.
6. Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
7. Search the list of unauthorised firms to avoid at **scamsmart.fca.org.uk/warninglist**
8. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme.
9. Think seriously about getting independent financial and professional advice before you hand over any money.
10. **Remember:** if it sounds too good to be true, it probably is!

Report a scam
If you are approached by fraudsters please tell the FCA using the FCA Consumer Helpline on **0800 111 6768**, or the share fraud reporting form at **fca.org.uk/scams**, where you can also find out more about investment scams.

If you have already paid money to share fraudsters you should contact Action Fraud on **0300 123 2040** or online at **actionfraud.police.uk**

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