

Annual Report 2019

BAE Systems plc

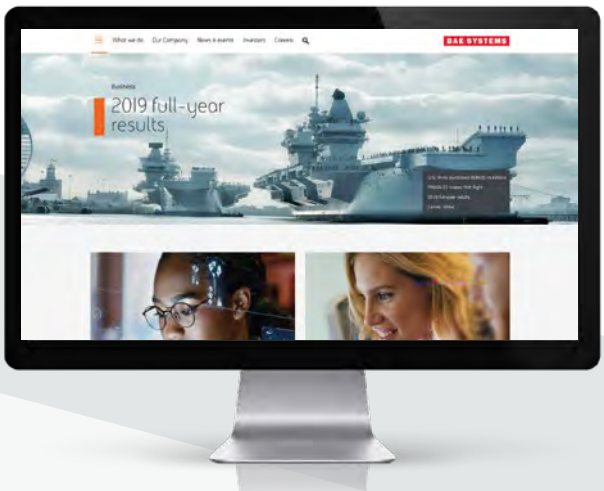
BAE SYSTEMS

Who we are

At BAE Systems, we provide some of the world's most **advanced, technology-led** defence, aerospace and security solutions.

We employ a skilled workforce of 87,800 people[1] in more than 40 countries. We help our customers to stay a step ahead when protecting people and national security, critical infrastructure and vital information.

We also work closely with local partners to support economic development through the transfer of knowledge, skills and technology.



Further information can be found online by visiting baesystems.com

232 Shareholder information

1. Including share of equity accounted investments.

Strategic report

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Cautionary statement: All statements other than statements of historical fact included in this document, including, without limitation, those regarding the financial condition, results, operations and businesses of BAE Systems and its strategy, plans and objectives and the markets and economies in which it operates, are forward-looking statements. Such forward-looking statements, which reflect management's assumptions made on the basis of information available to it at this time, involve known and unknown risks, uncertainties and other important factors which could cause the actual results, performance or achievements of BAE Systems or the markets and economies in which BAE Systems operates to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. 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.

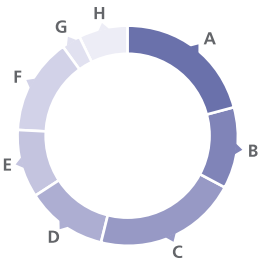
Our business at a glance

BAE Systems has strong, established positions in the air, maritime, land and cyber domains.



Air

- 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 electronics equipment for military aircraft
- In-service support of Tornado combat aircraft
- Manufacture, upgrade and in-service support of Hawk trainer aircraft
- Development of next-generation unmanned air systems and defence information systems
- 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



A	Typhoon	21%
B	F-35 Lightning II	12%
C	Defence electronics	21%
D	Tornado	12%
E	Commercial avionics	10%
F	Weapon systems	14%
G	Hawk	3%
H	Other	7%

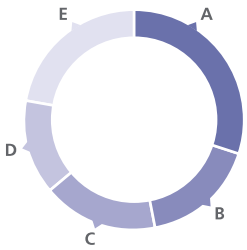
Sales[1] by domain

52%



Maritime

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



A	Submarines	30%
B	Complex warships	17%
C	US naval ship repair	17%
D	UK naval support	14%
E	Other	22%

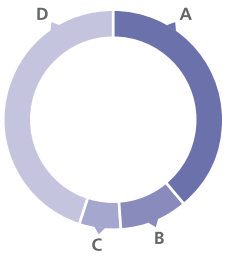
Sales[1] by domain

25%



Land

- 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 electric and 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	10%
C	Commercial	6%
D	Weapon systems/other	45%

Sales[1] by domain

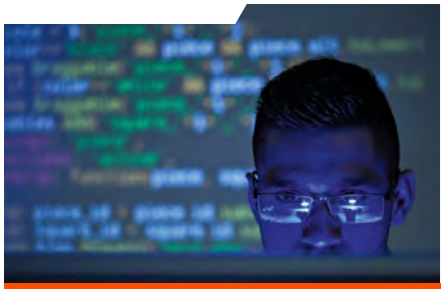
18%

2019 sales[1]

£20,109m

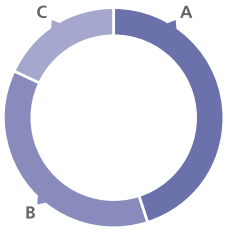
2019 revenue

£18,305m



Cyber

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



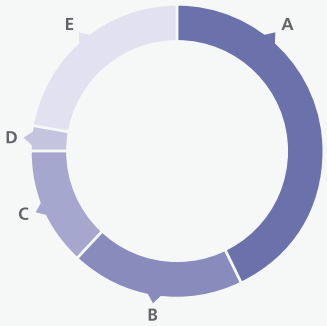
A	US government	45%
B	UK and other governments	37%
C	Commercial	18%

Sales[1] by domain

5%

Sales[1] by destination

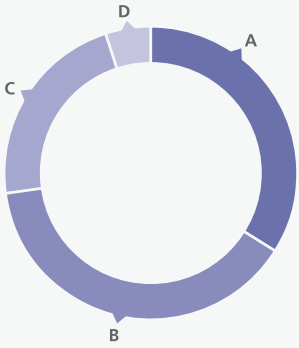
BAE Systems has leading positions in its principal markets – the US, UK, the Kingdom of Saudi Arabia and Australia – as well as established positions in a number of other international markets.



A	US	43%
B	UK	19%
C	Saudi Arabia	13%
D	Australia	3%
E	Other international markets[2]	22%

Sales[1] by activity

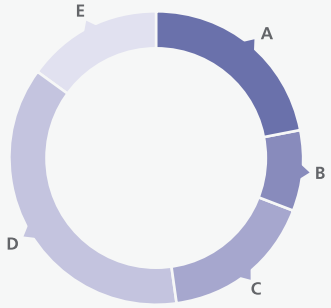
BAE Systems has a diverse portfolio, broadly balanced between an enduring services and support business, long-term platform and product programmes, electronic systems, and activities in cyber and intelligence.



A	Platforms	34%
B	Military and technical services and support	39%
C	Electronic systems	22%
D	Cyber	5%

Sales[1] by reporting segment

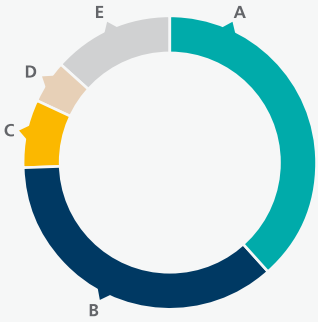
BAE Systems reports its performance through five principal reporting segments.



A	Electronic Systems	22%
B	Cyber & Intelligence	9%
C	Platforms & Services (US)	17%
D	Air	37%
E	Maritime	15%

Employees by location

BAE Systems employs a skilled workforce of 87,800 people[3] in more than 40 countries.



A	UK	33,800
B	US	31,700
C	Saudi Arabia	6,500
D	Australia	4,300
E	Other	11,500
Total employees[3]		**87,800**

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04 Our key products and services

35 Our people

1. Revenue plus the Group's share of revenue of equity accounted investments.
2. Includes £0.6bn (3%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.
3. Including share of equity accounted investments.

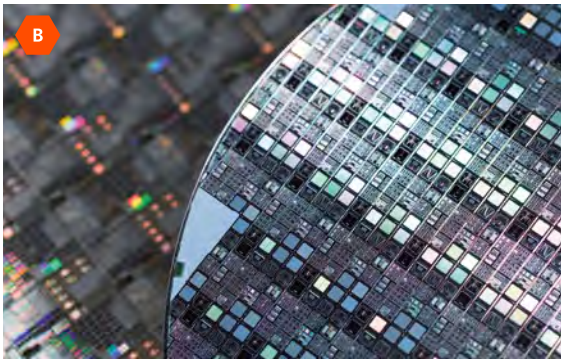
Our key products and services

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

A



B



C



D



E



F



G



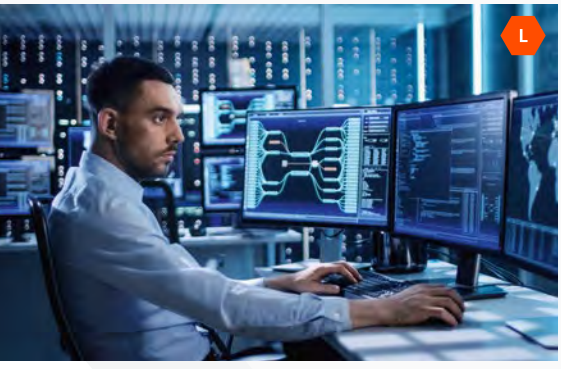
H











A F-35 Lightning II

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

B Defence electronics

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

C Air support and training

Provision of support to operational capability, including maintenance, support and training for Typhoon aircraft in service with the UK, Saudi Arabian and Omani air forces. Under the Saudi British Defence Co-operation Programme, delivery of contracts for manpower, logistics and training, training aircraft (including Hawk) and upgrades to Tornado aircraft in Saudi Arabia. Provision of support for Hawk aircraft in service in 14 countries and support for the F-35 Lightning II fleet and systems across the UK, US and Australia.

D Complex warships

Design and manufacture of two 65,000-tonne aircraft carriers, five Offshore Patrol Vessels and up to eight Type 26 frigates for the Royal Navy. The first Type 26 is expected to enter service in the mid-2020s. Contract signed in 2018 with the Australian government that provides the framework for the design and manufacture of Hunter Class frigates. Provider of design for the Canadian Surface Combatant programme.

E 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, with the remaining four boats in build. The final boat is expected to enter service in the mid-2020s. 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 commenced in 2016.

F Naval ship repair and support

Provision of naval ship repair and modernisation services in the US and UK, together with support to the navies of the US, UK and Australia. In the US, BAE Systems has facilities located on the Atlantic and Pacific coasts.

G Combat vehicles

Upgrade of tracked vehicles, including: Bradley Fighting Vehicles; M88 recovery vehicles; design and manufacture of the M109 self-propelled howitzer and Armored Multi-Purpose Vehicle; and development of light combat vehicles under the Mobile Protected Firepower programme for the US Army. Manufacture of amphibious vehicles for the US Marine Corps and international customers. Design, manufacture and support of the CV90 and BvS10 combat vehicles for international customers. Vehicle upgrade and support to the British Army through a joint venture with Rheinmetall.

H Typhoon and Hawk manufacture and capability development

Manufacture of Typhoon major units and final assembly of aircraft. In Qatar the contract signed in 2017 to provide Typhoon and Hawk aircraft along with a bespoke support and training package is progressing to plan. Expansion of the capabilities of the aircraft.

I Unmanned and future air system capabilities

Development of future air system capabilities, including joint investment with the UK government and industry in next-generation combat air systems. The Tempest programme was launched in 2018 in support of the UK Combat Air Strategy.

J 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 for GE, and is a major supplier of flight control electronics for Boeing and other aircraft platforms.

K 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 and operates complex ammunition plant operations for the US Army to produce insensitive munitions and propellant grains.

L 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 the financial services sector.

Group financial highlights

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

- Sales increased by £1.7bn, a 7% increase excluding the impact of currency translation[3].
- Underlying EBITA increased to £2,117m, a 5% increase on a constant currency basis[3] and excluding the impact of IFRS 16[4].
- Underlying earnings per share[4,5] increased by 7% to 45.8p, excluding the one-off tax benefit arising from agreements reached in respect of overseas tax matters, net of a provision taken in respect of the estimated exposure arising from the EU's decision regarding the UK's Controlled Foreign Company regime.
- Operating business cash flow[4] increased by £314m to £1,307m.
- Net debt decreased to £743m.
- Order intake[6] of £18.4bn.
- Order backlog[6] of £45.4bn.

Financial performance measures as defined by the Group

Sales

KPI

£20,109m

(2018 £18,407m)

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

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

Net debt

BONUS KPI

£(743)m

(2018 £(904)m)

Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments). Net debt does not include lease liabilities.

Purpose Allows management to monitor the indebtedness of the Group.

Underlying EBITA[4]

KPI

£2,117m

(2018 £1,928m)

Definition Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items[7].

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

Order intake[6]

BONUS KPI

£18,447m

(2018 £28,280m)

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.

Underlying earnings per share[4,5]

BONUS KPI

Excluding one-off tax benefit

45.8p (2018 42.9p)

Including one-off tax benefit

50.8p (2018 42.9p)

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[7].

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

Order backlog[6]

£45.4bn

(2018 £48.4bn)

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.

Operating business cash flow[4]

KPI

£1,307m

(2018 £993m)

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

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

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

BONUS 75% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 122).

Reconciliations from the financial performance measures as defined by the Group to the financial performance measures defined in IFRS[1] are provided in the Group financial review on pages 44 to 51.

- Revenue increased by £1.5bn, a 7% increase excluding the impact of currency translation[3].
- Operating profit[4] increased by £294m to £1,899m, including £27m of non-recurring charges (2018 £154m).
- Basic earnings per share[4] increased by 48% to 46.4p including the impact of the £161m one-off tax benefit.
- Net cash flow from operating activities[4] increased by £397m to £1,597m, with IFRS 16 net lease cash outflows of £273m now classified under financing and investing activities.
- Group's share of the pre-tax accounting net post-employment benefits deficit increased over the year by £0.5bn to £4.5bn.
- Final dividend of 13.8p making a total of 23.2p per share for the year, an increase of 4.5% over 2018.

Financial performance measures defined in IFRS[1]

Revenue

£18,305m

(2018 £16,821m)

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

Operating profit[4]

£1,899m

(2018 £1,605m)

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[4]

46.4p

(2018 31.3p)

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

Net cash flow from operating activities[4]

£1,597m

(2018 £1,200m)

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

Other financial highlights

Group's share of the net post-employment benefits deficit

£(4.5)bn

(2018 £(4.0)bn[8])

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

Dividend per share

23.2p

(2018 22.2p)

Definition Interim dividend paid and final dividend proposed per share.

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Current year compared with prior year translated at current year exchange rates.
4. The financial impact of the adoption of IFRS 16 Leases from 1 January 2019 is described on pages 44 to 51.
5. The one-off tax benefit is described on page 46.
6. Including share of equity accounted investments.
7. Items that are not relevant to an understanding of the Group's underlying performance (see page 46).
8. The Saudi Arabia end of service benefit obligation of £97m at 31 December 2018 has been reclassified from trade and other payables to post-employment benefit obligations.

Operational key points

In 2019, we delivered consistent and strong operational performance for our customers.





01 Ramp-up of F-35 production progressing well

The production ramp-up of the F-35 programme is progressing well with 142 aft fuselage sets completed in 2019 and full rate production levels targeted in 2020. A Block 4 electronic warfare capability upgrade contract was awarded in June.



02 Qatar contract amendment to accelerate Typhoon deliveries

The Qatar Typhoon and Hawk programme is meeting its contractual milestones with Typhoon aircraft now to be delivered to an accelerated schedule.



03 US Army M109 Combat Vehicles achieved delivery targets

The M109A7 programme addressed a number of corrective actions during the year and hit its delivery targets in the second half of the year.



04 Offshore Patrol Vessels programme on track for completion in 2020

The third of five Offshore Patrol Vessels, HMS Trent, was accepted by the Royal Navy in the year. The fourth ship was accepted in February 2020 and the final ship is expected to complete during 2020.



05 Continued progress on Type 26 warship in the UK, Australia and Canada

Manufacturing work on the Type 26 programme in the UK continues to increase following cut steel on the second ship in August. The first formal design review on the Hunter Class programme in Australia is scheduled for March 2020. Mobilisation activities on the Canadian Surface Combatant programme are progressing.



06 Working together to develop the Tempest Future Combat Air System

In July a Memorandum of Understanding was signed between the UK and Sweden, and in September a Statement of Intent agreed between the UK and Italy, committing the three governments to work together on next-generation combat air capability.

The Queen Elizabeth Class aircraft carrier build programme completed with HMS Prince of Wales entering Portsmouth in November and being accepted by the Royal Navy and commissioned alongside HMS Queen Elizabeth in December.



07 Queen Elizabeth Class aircraft carrier build programme achieves completion



08 First deliveries of US Marine Corps' Amphibious Combat Vehicles

The build process for the Amphibious Combat Vehicles is well underway, with the 13 testing and Low-Rate Initial Production vehicles having been delivered.

Electronic Systems has received an initial $184m (£139m) award for APKWS® under the recently announced five-year $2.7bn (£2.0bn) Indefinite Delivery, Indefinite Quantity contract.



09 Growing demand for Advanced Precision Kill Weapon System®



10 Naval Ship Repair sees first US tandem docking

The first tandem docking of two large warships has taken place at the San Diego shipyard, with the USS Stethem and USS Decatur in dock for refurbishment.

Chairman's letter

2019 proved to be another strong year for the Company and a valuable building block for growth in the years ahead as operational performance improved and strategic actions were taken.



Sir Roger Carr
Chairman

Our performance

2019 was a year in which we saw improving operational performance against a backdrop of continued geopolitical turbulence. I believe our customer relationships are the bedrock of the business and our strength derives from four key pillars: firstly, a deep order backlog and long-term programme positions giving multi-year visibility; secondly, a diverse portfolio in products and markets, original equipment manufacture, and aftermarket services; thirdly, customer focus; and finally, a track record of successful partnerships in international markets to develop local industry, employment and skills, which are key requisites in the modern defence and security market.

Operationally, major new programmes secured in 2018, including US Amphibious Combat Vehicles, Typhoon and Hawk production for Qatar, and Hunter Class frigates in Australia all mobilised and made progress. Established programmes in the US, Air and Maritime drove top line growth for the Group. Steady progress was made addressing problem programmes in Platforms & Services (US) and Maritime. In the year we saw two very long-standing programmes come to an end with the successful retirement from service of the UK Tornado fleet and the completion of the UK's Queen Elizabeth and Prince of Wales aircraft carriers.

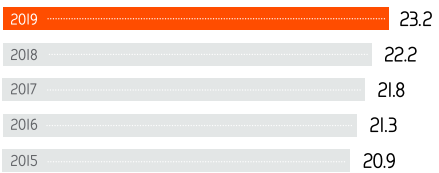
Overall, the Group maintained its strong balance between production and aftermarket services in terms of both revenue and margin. Equally, the geographic mix of the business evolved as our US and International business continued to grow and our UK and Kingdom of Saudi Arabia revenues remained stable.

In summary, 2019 proved to be another strong year for the Company and a valuable building block for growth in the year ahead.

In January this year we announced that we had entered into definitive Asset Purchase Agreements to acquire Collins Aerospace's Military Global Positioning System business and Raytheon's Airborne Tactical Radios business. These two proposed acquisitions represent a unique opportunity to purchase high-quality technology-based businesses with market-leading capabilities and long histories of pioneering innovation in their fields. Together we believe these businesses will reinforce our position in the Electronic Systems sector and accelerate the growth profile of the business in the coming years.

Five-year dividend history

(pence)



Dividend

(pence)

23.2p

+4.5%

Our role

During the course of the year, there has been an increased focus from investors and the public as to the sustainability of our business, its purpose and its role in our communities.

As Chairman and as a Board, we have long held the view that it is not simply how much money we make, but how we make money that is of crucial importance.

As an industry, our activities are amongst the most highly regulated of any sector. Our defence exports are approved by the UK, US or other relevant governments and we carefully observe the rules and regulations which apply.

In addition, whilst the business is complex and technically challenging, as Chairman, I believe the following principles capture the purpose of our organisation from apprentice to boardroom:

- we are proud of what we do in serving and equipping those who serve and protect us;
- we inspire and excel in the work we do, the technologies we develop, and the talent we build;
- we place safety above profit, people above process, ethics above outcomes – in a workplace culture that rewards merit, values diversity, and cares for the environment;
- we work with our customers in a spirit of partnership combining self-interest and nations' interests;
- we go the extra mile in the products that we make, the quality we deliver, and the services we offer;
- we recognise we are entitled to nothing and must earn everything;
- we seek to reward our stakeholders by honing our competitive edge, selling internationally, innovating constantly and executing flawlessly;
- we observe all applicable rules and regulations in the way we do business, and seek to do the right thing simply because it is the right thing to do;
- we trade responsibly, account conservatively, act with integrity and govern to ensure the long-term sustainability of the Company; and
- at the heart of our business – we are performance driven and values led.

These principles cannot always be measured or quantified, but I believe they reflect a mindset which sits alongside the skillset that delivers Charles Woodburn's three strategic priorities of: driving operational excellence; improving competitiveness and efficiency; and advancing our technology.

I believe by fusing this sense of purpose with our actions, we will continue to operate and build a sustainable business of which all our stakeholders may be proud.

Our strategy

The strategy of the Company remains unchanged (see pages 18 and 19). This includes continuing to focus on the design, development and delivery of products and services as a world leader in the defence industry. We aim to employ technology in improving efficiency and competitiveness to succeed in defence and adjacent markets.

As a Board, we consider carefully the application of our cash resources to ensure a balance between the support of our pensions commitments, investment in the business, the reward of shareholders and the acquisition of companies, technologies or assets which support and sustain our strategy and add value to the Group.

Our strategy is reviewed regularly as part of normal Board discussion and carefully appraised at least annually at a separate Board event. In evolving the strategy, we respect the importance of government relationships and their commitment to defence spending. In a turbulent world, it is evident that governments are clear that protection of their people is a key priority and the allocation of funds to defence continues to underpin our strategy worldwide.

Politically, the outcome of the UK general election and the conclusion of the agreement to withdraw the UK from the EU has brought greater stability. Our relationships in the US, the Middle East and Australia are strong and constructive. It remains the case however, that the Group is reliant on the approval of export licences by a number of governments in order to provide capability to the Kingdom of Saudi Arabia. The withholding of such licences may have an adverse effect on our ability to provide such capability and we will seek to work closely with the UK government to manage the impact of any such occurrence in the months ahead.

Looking forward, our energies will remain focused on executing our strong order book successfully, reinforcing our position in the higher growth markets of our business, investing in new products and technologies and ensuring we have the talent to deliver sustained stakeholder rewards.

Our people

During the course of the year, considerable progress has been made in managing succession and developing the executive team as some roles end in retirement and new career opportunities emerge across the organisation.

The appointment of Charles Woodburn as Chief Executive was an important and successful step in ensuring the Group is equipped with and led by an individual of considerable talent, ability, energy and enthusiasm with a vision for the future and a commitment to daily delivery.

Our strategy in action

Employee engagement

Our Chairman and Board regularly engage directly with our employees, often while visiting our sites.

Sir Roger Carr, our Chairman, visited the Naval Ships business in Govan, Scotland. He received a detailed update on the business, saw HMS Glasgow and HMS Cardiff in build and met the Commander Officer and his team from HMS Tamar, our fourth Offshore Patrol Vessel.

He also met a number of apprentices and spent time with other members of the Naval Ships team in order to see the progress being made across programmes and in our teams.

18 Group strategic framework
More online baesystems.com

In the two years Charles has held the role of Chief Executive, he has systematically built and strengthened his team with a mix of internal promotions and external hires, having acute awareness of balancing seasoned knowledge with fresh thinking. Evidence of the success of these moves is visible in all parts of the organisation and I am confident that the programme will continue in the coming 12 months with a refreshed and talented executive team.

Whilst embedding leadership changes, the importance of having a strong pipeline of skills has not been overlooked. As a company we believe in the value of apprenticeships and continue to invest in high-quality training facilities as a foundation for developing the approximately 800 UK apprentices and 250 graduates we will aim to recruit this year. Talent remains our most valuable asset and building our own firm base of skills and abilities through high-quality training has proved to be a winning formula.

Our Board

The Board is a valuable diverse mix of gender, experience and skills with talent drawn from different countries, industries and age groups. It is a Board I feel privileged to chair and appreciative of the valuable counsel they offer in both the strategic direction and operational performance of the business. Each member continues to demonstrate great enthusiasm for their role, a deep commitment to the business and a willingness to give unselfishly of their time and knowledge. Board chemistry is excellent enabling an atmosphere that encourages freedom of expression, debate and considered decision-making.

Time served has been carefully considered and we currently have a good balance of seasoned experience and recently-recruited capability.



Non-executive directors
We are respectful of UK governance recommendations on non-executive directors serving a maximum of nine years to preserve independence. Sadly, adherence to this recommendation results in the loss of considerable talent and experience from the Board which is inevitably much missed in a complex international business.

In seeking to preserve valuable experience, in 2018 we received approval to extend the term of our Senior Independent Non-Executive Director, Nick Rose, by one year, but it is with great regret that he must now stand down in February 2020.

Similarly, we were sorry to lose Harriet Green, who stepped down from the Board in November 2019 after nine years' invaluable service.

I am delighted that Paula Rosput Reynolds, who chairs our Remuneration Committee, has agreed to remain on the Board for a further year with support from our major shareholders.

During the course of 2020 we will be seeking to recruit two new non-executive directors as part of our continuous succession planning.

Executive directors
2020 will be a year of change within the executive director leadership team. Peter Lynas, the Group Finance Director, will retire in March having served the Company and its predecessor businesses since 1985. Peter reinforced the rigour, discipline and structure of our financial systems and provided wise and seasoned management oversight to ensure the quality of our earnings, the health of our balance sheet and the trust of our stakeholders.

Similarly, Jerry DeMuro, the Chief Executive Officer of BAE Systems, Inc., will retire from the Board in March having joined the Company in 2014 after an outstanding career at senior levels within the defence industry. Jerry has led our Inc. business with considerable skill and has overseen the remarkable growth of our US business, most notably, the Electronic Systems sector which is a world leader in its field.

Peter and Jerry will leave the Group having been major contributors to its operational success, cultural development and stakeholder reputation.

Following their departures, there will be a seamless transition in April by the recently-recruited Brad Greve to Group Finance Director, who will have had an induction period of seven months in the business prior to stepping up to the role and by Tom Arseneault, currently President & Chief Operating Officer of BAE Systems, Inc., to President and Chief Executive Officer of BAE Systems, Inc.

Summary

In summary, we are pleased to have delivered another year of strong performance with sales of £20.1bn, underlying earnings per share of 45.8p, underpinned by an order backlog of £45.4bn and free cash flow of £850m.

The fundamentals of the business are sound, the order backlog substantial and the management team strong.

The Board therefore has recommended a final dividend of 13.8p for a total of 23.2p for the full year. Subject to shareholder approval at the May 2020 Annual General Meeting, the dividend will be paid on 1 June 2020 to holders of ordinary shares registered on 17 April 2020.



Sir Roger Carr
Chairman

Chief Executive's review

BAE Systems improved its operational performance in 2019, delivered a good set of results and we continued to progress our strategic objectives, execution on which provides the basis for long-term sustainability and generation of shareholder value.



The Group maintained its strong balance between production and aftermarket services in terms of both revenue and margin, and the geographic mix of the business continued to evolve as our US and International business continued to grow and our UK and Kingdom of Saudi Arabia revenues remained stable.

Charles Woodburn
Chief Executive

Introduction

In 2019, we delivered a good set of financial results underpinned by improving operational performance. Governments in our key markets continue to prioritise defence and security and there is a strong demand for our capabilities, products and services.

BAE Systems is a resilient company with long-term strength from its programmes, technologies, customer relationships and sustainability agenda. The Group maintained its strong balance between production and aftermarket services in terms of both revenue and margin, and the geographic mix of the business continued to evolve as our US and International business continued to grow and our UK and Kingdom of Saudi Arabia revenues remained stable. Following the significant international wins in recent years, as these programmes ramp-up they will become the second-largest revenue drivers for the Group behind our US-based businesses.

The Group strategy remains focused, consistent and is delivering results. Execution on the key strategic objectives of operational excellence, competitiveness and technological innovation is vital for the successful delivery of our order backlog, to deliver future growth and a high-performing sustainable business. Good progress in all areas was made in 2019.

Operationally, programme performance improvement is now being delivered. We will continue to drive programme performance to ensure successful delivery of our order backlog and the expected improvements in long-term cash generation. However, our safety performance in the year fell below our high expectations. The safety and wellbeing of our employees is paramount. To that end, we have sought external expertise to review a number of our sites and strengthened our team with new heads of safety in the UK and US to refocus and sharpen our thinking in this critical area.

Investment in self-funded research and development increased in the year and our portfolio was further bolstered by two technology-focused acquisitions. We aim to further increase technology funding in the coming years especially in Air and Electronic Systems as we look to maintain and enhance our long-term strategic positions.

We recognise that the way we do business and the actions and behaviours we demonstrate are vital for the long-term strength and sustainability of our business. Our behaviours are integral to the delivery of our strategy as we look to empower employees, create a diverse and inclusive working environment, recruit and retain talent and invest in technology and new facilities. Strong governance is at the heart of everything we do. This provides the base from which environmental and social activities are embedded in the business to deliver a positive social impact, a sustainable business, and ensure we do business in the right way.

2019 performance

US

Our US-based portfolio remains well aligned with customer priorities and the key focus areas outlined in the US National Defense Strategy.

The passage and signing of the fiscal year 2020 Defense Appropriations bill ended the Continuing Resolution and maintained funding support for many key BAE Systems programmes, including combat vehicles, F-35, electronic warfare programmes, and current and future precision weapons systems.

The fiscal year 2020 measure includes a top line budget of $738bn for defence, a 3% increase over 2019, and lawmakers have already agreed to a bipartisan deal setting the defence spending caps for fiscal year 2021 at $740.5bn. Whilst we remain cautiously optimistic about the budget process, numerous ongoing political issues may continue to detract from the timely passage of appropriations legislation.

Our US electronics business delivered another standout operational performance in 2019, especially in our core franchise positions in the high-technology areas of electronic warfare, precision-guided munitions, Intelligence, Surveillance and Reconnaissance, and electro-optics. The business closed with a record order backlog and the outlook for all its defence-focused divisions is positive with the portfolio well positioned to address key growth areas. These capabilities are also being leveraged on international as well as domestic programmes.

The Controls and Avionics and Power and Propulsion Solutions businesses are leveraging capabilities from our defence base to provide adjacencies into the commercial markets, giving exposure to the expanding civil aerospace market through our engine and flight control franchises.

The business remains focused on investment in emerging technologies and leveraging customer funding to maintain, develop and grow our strong market positions. Aligned with this strategy, Electronic Systems acquired the Riptide Autonomous Solutions business, a developer of unmanned underwater vehicles, in June 2019.

In January 2020, the Group announced two asset purchase agreements worth a total estimated $2.2bn for the proposed acquisitions of Collins Aerospace's Military Global Positioning System business and Raytheon's Airborne Tactical Radios business, both of which would be integrated into the Electronic Systems portfolio. These proposed acquisitions are conditional upon the successful closing of the pending Raytheon and United Technologies Corporation merger, as well as other customary closing conditions and required US regulatory approvals.

Platforms & Services (US) made steady progress in addressing its operational challenges. The US-based combat vehicles business is implementing a number of process and automation improvements to meet increased production volumes across multiple programmes with lessons learned being applied across the portfolio. The M109A7 met its delivery targets in the second half of the year and initial deliveries were made on the Amphibious Combat Vehicle programme. Further contract awards were received for the M88A3 modernisation and Bradley A4 programmes, strengthening the order backlog. Looking into 2020 the business will have three upgrade and three new-build programmes ramping up through its facilities.



38 Our values

The sector continued to shape its market-leading US naval ship repair business, maintaining a strong bid pipeline for repair and modernisation services, and working with the US Navy to improve utilisation levels. To this end, it was a strategic step forward in October when the first destroyer tandem docking in our San Diego facility was achieved. The ship repair and naval guns franchises are well supported by the growth outlook in the US Navy budget and projected fleet size. With the delivery of the final constructed ship in March and the sale of the Mobile shipyard, we exited commercial shipbuilding.

In our US-based Intelligence & Security business, we are maintaining a high level of bid activity and a strong pipeline despite a highly competitive and evolving market. The business is delivering on contracts with good programme and financial performance in the year.

UK

The UK is Europe's largest defence market. The UK government recently stated its commitment to uphold the NATO commitment to spend at least 2% of Gross Domestic Product on defence, and to increase the defence budget by at least 0.5% above inflation, in every year of the current parliament. The government is also expected to launch an Integrated Foreign Policy, Defence and Security Review during the course of 2020.

The work under the Team Tempest contract to develop next-generation combat air technologies, skills and expertise, in collaboration with UK government and industry partners, continues at pace. In the second half of the year the commitment of both Sweden and Italy to work with the UK on creating next-generation combat air capability was a welcome development.

During 2019, we remained focused on the execution of our long-term contracted positions in Air and Maritime.

In Air, the production ramp-up of rear fuselage assemblies for the F-35 Lightning II aircraft progressed well with 142 sets delivered. Full-rate production levels of approximately 160 sets are targeted in 2020. As the UK and global fleets grow, securing a long-term support position on the F-35 Lightning II remains a key focus.

With imminent completion of the current partner nation deliveries, Typhoon production is now focused on the sub-assembly build on the Kuwait and Qatar programmes, which sustain production into the mid-2020s. The potential pipeline for Typhoon additional orders remains positive, with opportunities both with partner nations and through exports with existing and new customers. Securing additional orders would extend production revenue levels.

Typhoon support delivered the expected operational performance levels and, with the Centurion standard having been declared, the UK Tornado fleet successfully retired from service on schedule.

In Maritime, the aircraft carrier build programme was completed with HMS Prince of Wales being accepted by the customer. The Offshore Patrol Vessels programme stabilised in the year delivering the second and third ships. The fourth ship was accepted in February 2020, and the final ship is expected to complete this year. Manufacturing work on the Type 26 programme in the UK continues to increase following cut steel on the second ship in August. Activity on the Dreadnought programme ramped up throughout the year with revenues now exceeding those on the Astute programme. The associated major programme of building works continued to progress.

BAE Systems will of course support the UK government in achieving its aim to ensure that the UK maintains its key role in European security and defence post-Brexit and to strengthen bilateral relationships with key partners in Europe. This will be important for ongoing collaboration in the development of defence capabilities.

The Group has relatively limited UK-EU trading and the majority of persons employed in the UK are UK nationals, with only limited movement of EU nationals into and out of the Group's UK businesses. Accordingly, the resulting Brexit near-term impacts across the business are likely to be limited.



International

Our defence and security capabilities remain highly relevant in an uncertain global environment with complex threats. During 2019, we further widened our international reach through the export win in Canada and a number of Foreign Military Sales through our Electronic Systems business. There are good prospects in existing and new international markets for our products and services in air, maritime, land and cyber security. Defence and security remains high on national agendas with the need in many cases to recapitalise or upgrade ageing equipment.

In Saudi Arabia, we continue to work closely with industry partners and UK government to ensure that the export licences required to enable us to fulfil our contractual obligations in the Kingdom are in place. On the Hawk programme, the first in-Kingdom final assembled aircraft were completed and entered into service.

BAE Systems continues to address current and potential new requirements as part of long-standing agreements between the UK government and the Saudi Arabian government as we continue to work on the localisation of defence capabilities in Saudi Arabia, in support of the Saudi Arabian government's National Transformation Plan and Vision 2030. Over many years, the Group has developed and taken shareholdings in local Saudi businesses. The Group is restructuring its portfolio of interests in these businesses and in the year, it disposed of its shareholding in Aircraft Accessories and Components Company. Following the Group's subsidiary, Overhaul and Maintenance Company, entering into a heads of terms for the sale of its 50% shareholding in Advanced Electronics Company to Saudi Arabian Military Industries, negotiations are continuing and the transaction is expected to take place in 2020.

In Qatar the contract between BAE Systems and the Government of the State of Qatar for the supply of 24 Typhoon and nine Hawk aircraft to the Qatar Amiri Air Force, along with a bespoke support and training package, is meeting its contractual milestones with Typhoon aircraft delivery now aligned to an accelerated schedule which was agreed in the year.

In Australia, the initial four-year design and productionisation phase on the Hunter Class programme commenced and the first formal integrated baseline review is scheduled to commence in Q1 2020. Production of the first ship is expected to commence in South Australia in the early 2020s. This Hunter Class programme will, over time, double the size of our current Australian business.

Following contract signing in February 2019, BAE Systems is providing the design, based on the Type 26, for the Canadian Surface Combatant programme. Mobilisation activities are progressing on the programme.

Whilst operating under a difficult geopolitical backdrop, the MBDA joint venture has continued to win orders in both domestic and international markets. The business continues to invest in new products and is well placed to benefit from defence spend increases in a number of European countries and international opportunities.

Cyber security

In our Applied Intelligence business, the UK Government Services division performed well. Following a strategic review, the Group commenced a process for the disposal of the Applied Intelligence US-based software-as-a-service business and decided to exit the UK-based Managed Security Services business. Cyber security is an increasingly important part of government security and a core element of stewardship for companies in a sophisticated and persistent threat environment. The services and products we offer in the remaining core business, including the Financial Services division, are expected to drive growth and improved returns as the market continues to develop.

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 pursue 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. Investment in value-enhancing acquisitions and returns to shareholders through a share buyback will be considered in line with our clear and consistent strategy and capital allocation policy.

A $1bn 6.375% bond, of which $500m had been converted to a floating rate bond by utilising interest rate swaps, matured and was repaid in June 2019.

Post-employment benefits schemes

The Group's share of the pre-tax accounting net post-employment benefits deficit increased to £4.5bn (2018 £4.0bn). The impact of lower discount rates increasing liabilities was in some part offset by good asset returns and changes in mortality assumptions.

In October 2019, six of the Group's nine UK pension schemes (including the two largest schemes) were consolidated into a single scheme. Following that consolidation, the Company agreed with the new Trustee Board to bring forward the funding valuation of the combined scheme to 31 October 2019 from the previously scheduled date of 31 March 2020.

After consultation with The Pensions Regulator in the UK, the Group has reached agreement with the Trustee Board of the combined scheme on the accelerated funding valuation and revised deficit recovery plan.

At the 31 October 2019 funding valuation date, the deficit was £1.9bn. The current deficit recovery plan which runs to 2026 will be replaced by a new deficit recovery plan, under which a one-off payment of £1bn is to be made in the coming months, with approximately £240m of funding payable in the scheme year ending 31 March 2020 and approximately £250m by 31 March 2021.

Executive Committee changes

At the start of 2019 David Armstrong was appointed as Group Business Development Director following Alan Garwood's retirement. In June, Mark Phillips was appointed Group Communications Director and in May, Andrew Wolstenholme left the Company and was replaced by Glynn Phillips as Group Managing Director Maritime. Brad Greve joined the Executive Committee in September following his appointment as Group Finance Director designate to succeed Peter Lynas and joins the BAE Systems plc Board on 1 April 2020. At the start of 2020 Ben Hudson was appointed as Chief Technology Officer, replacing Nigel Whitehead who announced his intention to retire.

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 strategy is clear and well defined with governments in our key markets continuing to prioritise defence and security, with strong demand for our capabilities. Through execution of our strategy, BAE Systems is well placed to maximise opportunities, deal with the challenges and deliver a business focused on sustainability and generating shareholder value.



Charles Woodburn
Chief Executive

Group strategic framework

Our strategy is comprised of five key long-term areas of focus that will help us to achieve our vision and mission. It is centred on maintaining and growing our core franchises and securing growth opportunities through advancing our three strategic priorities and demonstrating the Company behaviours.

Our vision

To be the premier international defence, aerospace and security company

Our mission

To provide a vital advantage to help our customers to protect what really matters

Our strategy

		Progress during the year	Outlook
1	Maintain and grow our defence business	– Sales growth of 7% on a constant currency basis – all sectors delivered sales growth – US business book-to-bill ratio of over one – Number of major programmes ramping up in Electronic Systems, US Combat Vehicles and Air – Design partner on 15-ship Canadian Surface Combatant programme – Increased self-funded R&D spend	– Strong order backlog and established positions on long-term programmes provide a strong platform to deliver growth in mid term – Opportunities in Air – Typhoon orders, F-35 sustainment, MBDA – Opportunities in Electronic Systems to maintain growth outlook – Opportunities in US Combat Vehicles – growth expected from existing programmes and international opportunities – Geopolitical risks still remain
2	Continue to grow our business in adjacent markets	– Commercial work in Electronic Systems increased in the year – Our battery electric and fuel cell electric systems recorded five million zero emission miles – Financial Services within Applied Intelligence secured 6% increase in order intake	– Well placed to benefit from the continued growth in the commercial aerospace market – Cyber security opportunities with allied governments and global financial services markets – Our hybrid propulsion technology is well placed as demand for low and zero emission technology grows
3	Develop and expand our international business	– Qatar programme ramping up – MBDA revenue growth – M777 in India – first deliveries in partnership with Mahindra Defence Systems Ltd – Continue to widen reach and relationships in targeted end markets	– Opportunities to further positions in current International markets and develop new markets – Strong bid pipeline in Europe, Middle East and Asia Pacific
4	Inspire and develop a diverse workforce to drive success	– Introduced future-focused company behaviours and sharpened our approach to performance management – Improved talent identification and succession planning – Strategic workforce plans helping identify and plan for critical skills requirements – Continued focus on early careers – recruited over 700 apprentices in the UK – Increased accountability and leadership visibility on diversity and inclusion commitments	– Focus on enhancing our employer brand and recruitment practices to meet hiring requirements in some of our markets – Invest in developing and recruiting future-critical skills among new generations to establish medium- to long-term skills pipeline – Accelerate work on talent identification and career development to ensure robust succession plans – Focus on inclusion and increase representation of women in leadership and engineering roles
5	Enhance financial performance and deliver sustainable growth in shareholder value	– Strong financial performance – Enabled a dividend increase of 4.5%	– Strong order backlog and established positions on long-term programmes provide a strong platform to deliver mid-term growth – Focus on expanding long-term cash generation

Our values

Trusted

Through successful execution of this strategy we look to deliver a high-performing, well-run sustainable business which will deliver long-term shareholder value.

Our strategic priorities

Our three strategic priorities which are embedded throughout the Group provide the link between our longer-term strategy and near-term business objectives for all our employees.

Drive operational excellence

Successes in 2019
- Offshore Patrol Vessel and M109 programmes stabilised
- Management strengthened with a blend of internal promotions and external hires
- Leading Complex Projects, Programmes and Portfolios (LCP3) development programme rolled out
- HMS Prince of Wales delivered and commissioned on schedule

Our priorities for 2020
- US Combat Vehicles long-term multi-programme delivery
- Enhance recruitment practices and further leverage strategic workforce planning to deliver business plans
- Engineering leaders development programme roll-out

Continuously improve competitiveness and efficiency

Successes in 2019
- Supply chain targets achieved
- Spend analytic tool implemented and 'Partner to Win' programme established
- Process improvements and robotic welding machines installed in US Combat Vehicles
- First destroyer tandem docking in San Diego

Our priorities for 2020
- Continue to drive supply chain savings and 'Partner to Win' programme
- Increased collaboration across the Group and with industry partners
- Continued focus on identifying and securing talent and critical skills to fulfil future requirements

Advance and further leverage our technology

Successes in 2019
- Increased year-on-year self-funded R&D spend by 7%
- Riptide and Prismatic acquisitions
- Tempest programme advancement
- Increased level of classified work
- FAST LABs™ awards for leading-edge technology development, such as machine-learning capabilities for space situational awareness

Our priorities for 2020
- Target further increases in self-funded R&D spend and technology bolt-on acquisitions
- Continue to accelerate our investment in Electronic Systems' strategic priority areas
- Continue to develop UK university partnerships

Innovative | Bold

Our markets

BAE Systems has leading positions in its principal markets – in the US, UK, the Kingdom of Saudi Arabia and Australia – as well as established positions in a number of other international markets. We are one of the largest global defence and security companies.

Supporting our customers

Our strategy is focused on providing a vital advantage to our customers around the world. In particular, we have built strong positions aligned with our core defence platforms to support our customers in our four principal markets. These principal markets – the US, UK, the Kingdom of Saudi Arabia and Australia – have been identified as having a significant and sustained commitment to defence and security. BAE Systems has established strong and enduring relationships in these markets and is recognised as playing a key role in the industrial capability of each of these countries.

Our unique position and capabilities

Our strong position in the US through the Special Security Agreement, together with our standing as the leading defence contractor in the UK, provides us with unique capabilities that can be leveraged across the Group to support our customers. In addition, our diverse portfolio of capabilities in the air, maritime, land and cyber domains, provides us with a comprehensive offering for our customers around the world making us one of the broadest and most geographically diverse major defence companies.

Responding to changes in defence and security requirements

Our business continues to respond to geopolitical and technology trends that will influence and shape our customers' defence and security requirements now and in the future. Our excellence in complex engineering, developing cutting-edge technology and seeking innovative solutions enables us to respond to our customers' requirements for greater agility, global reach, and advanced technology products and services.

Growth aspirations

In recent years a number of key markets for the Group have either returned to growth or stabilised spending in response to an increasingly uncertain and multi-threat security environment. This has provided a growth platform for the Group in 2019 and the coming years.

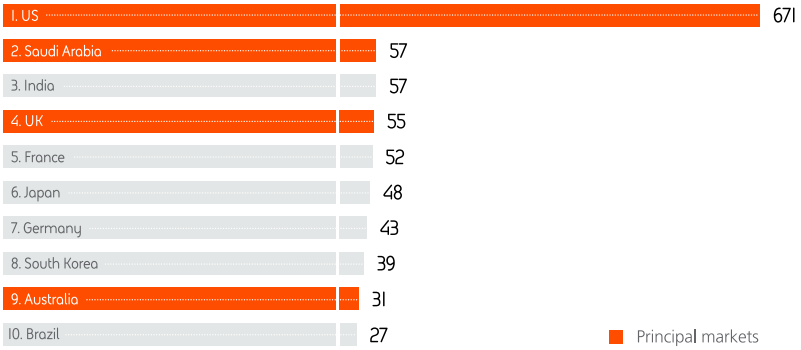
We have a significant and increasing international presence following a number of significant wins in the last few years. Through long-standing customer relationships and continuing to develop new ones, combined with the ability to leverage our range of capabilities around the Group, we continue to see further opportunities in a number of international markets.



66 Air

Accessible global defence markets[1]

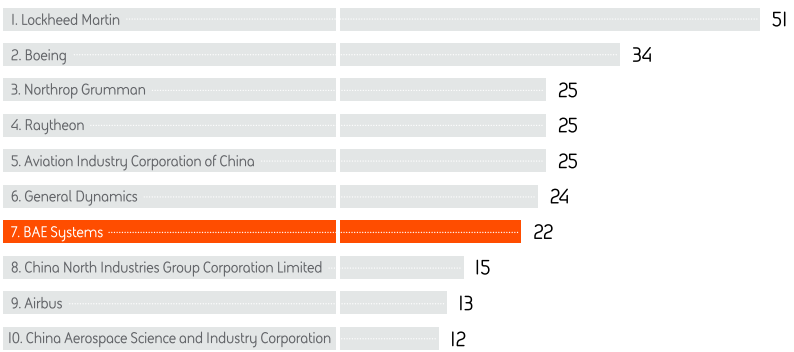
Top ten global defence markets accessible for business by the Group ($bn)



Source: 2018 US budget as shown in the Department of Defense Fiscal Year 2020 Budget Request and, outside the US, Jane's Defence Budgets (based on 2018 total defence budgets and constant 2019 US dollars).

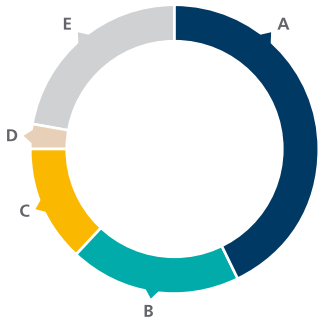
BAE Systems' global defence market position

Top ten global defence contractors' revenue ($bn)



Source: Defense News Top 100 for 2019 (based on 2018 numbers). Exchange rate applied to BAE Systems is $1.276/£1.

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



Sales[1] by destination

A	US	43%
B	UK	19%
C	Saudi Arabia	13%
D	Australia	3%
E	Other international markets[2]	22%

US

The US continues to represent the single largest defence market in the world. BAE Systems remains a top ten defence supplier in the US.

In July 2019 a two-year budget agreement was signed to lift the deficit ceiling and budget caps. The fiscal year 2020 appropriations bill was passed in December, closing out the Continuing Resolution. The fiscal year 2020 measure and the currently established fiscal year 2021 defence spending cap continue to demonstrate strong bi-partisan support for defence, and maintains support for our medium-term planning assumptions and positive momentum for military readiness and modernisation programmes.

The portfolio of the US-based business is well-aligned with customer priorities and growth areas as outlined in the National Defense Strategy, which include combat vehicles, precision-guided munitions, naval ship repair and modernisation services, electronic warfare, hypersonics and space security.

BAE Systems has strong positions on a number of premier defence programmes, including F-35 Lightning II, M109 self-propelled howitzer, Armored Multi-Purpose Vehicle, Amphibious Combat Vehicle and we are a leader in advanced electronic systems, real-time intelligence and analysis, naval gun systems and artillery systems.

In addition to our position on US defence programmes, the US-based portfolio is also focused on Foreign Military Sales and direct international sales to allied nations.

We continue to deliver on and look to enhance existing commercial programmes, including engine and flight controls, and electric drive propulsion systems.

Sales[1]

£8,642m



62 Platforms & Services (US)

1. Revenue plus the Group's share of revenue of equity accounted investments.
2. Includes £0.6bn (3%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

UK

BAE Systems remains the largest defence company in the UK, with strong and long-standing relationships with the Ministry of Defence and our supply chain.

The UK is Europe's largest defence market. The UK government recently stated its commitment to uphold the NATO commitment to spend at least 2% of Gross Domestic Product on defence and to increase the defence budget by at least 0.5% above inflation, in every year of the current parliament. The government is also expected to launch an Integrated Foreign Policy, Defence and Security Review during 2020.

The UK Combat Air Strategy announced in July 2018 and the existing National Shipbuilding Strategy send a strong signal about the UK's commitment to retaining a leading position in the combat air and maritime domains. These strategies enable long-term planning and joint government and industry investment in next-generation platforms, systems and technologies and the workforce required to deliver them.

BAE Systems plays an important role in providing capabilities to support the UK government and armed forces in the air, maritime, land and cyber domains. Our involvement across the major UK defence programmes, including Typhoon aircraft, Queen Elizabeth Class aircraft carriers, Type 26 frigates, and Astute and Dreadnought Class submarines, maintains our diverse skillsets, allowing us to provide a vital advantage to our UK customers and in some circumstances provide exportable products and services. The UK government provides vital support in the pursuit of international export opportunities, recognising the value that BAE Systems and the defence industry contributes to the UK economy.

Our UK-managed global cyber business has a focused strategy to ensure that we support our government and commercial customers as cyber security becomes an increasingly important part of a sophisticated and persistent threat environment.

Sales[1]

£3,850m



Saudi Arabia

The Kingdom of Saudi Arabia continues to be a leading military power and one of the largest defence markets globally.

Saudi Arabia has a strong commitment to defence and security spending driven by regional security instability.

Saudi Arabia's Vision 2030 strategy to promote in-Kingdom industrialisation and diversification away from reliance on oil continues to shape our activities in support of Saudi Arabia's national objectives of technology development, local skills, and the development of an indigenous defence industry and capability. Through the restructuring of the Group's portfolio of interests in a number of industrial companies, along with sustaining current industrialised capability and building on our strong history in Saudi Arabia, we are working with Saudi Arabian Military Industries (SAMI) to explore how we can collaborate to deliver further In-Kingdom Industrial Participation.

We remain well placed as a leading in-country contractor in support of air defence platforms and training systems for the Royal Saudi Air Force, as well as support for mine countermeasure vessels for the Royal Saudi Naval Forces.

Sales[1]

£2,693m

Australia

BAE Systems is one of the largest defence companies in Australia, with strong activities across all domains.

Regional instability and the rapid pace of military modernisation and technology advancement in the Asia-Pacific region continue to drive the government's commitment to defence spending, with major recapitalisation programmes underway in the air, maritime and land domains.

The government has indicated its intent to grow defence spending by committing to spend 2% of Gross Domestic Product by 2020/21. As part of this commitment, the government has made clear its objective to build a stronger, sustainable and internationally competitive domestic defence industry, ensuring that over time the nation has in place a sovereign industrial base that has the skills, knowledge and capability to manage and support the platforms and systems in which it has invested as well as exporting its own products and services.

We are well positioned to support this through an established business and a workforce based at more than 25 sites across the country, in addition to our ability to leverage our international positions within the Group to support domestic Australian products in international markets.

We currently provide support to the Australian Defence Force through engineering, programme management and sustainment solutions, including the Jindalee Operational Radar Network upgrade, Hawk Lead-In Fighter support, F-35 Lightning II sustainment, and Anzac frigate support and upgrade. The award to BAE Systems Australia in 2018 of the nine-ship Hunter Class Frigate programme, to be built at the ASC Shipbuilding leased shipyard facility in Adelaide will in time give the business a balanced portfolio of build and support work.

Sales[1]

£667m

International

BAE Systems has many strong and enduring relationships in other international markets.

Regional security tensions, the growing emphasis on indigenous capabilities and varying economic conditions continue to influence defence spending internationally. In Asia-Pacific and the Middle East, BAE Systems has developed and seeks to further relationships with partners and customers in a number of countries.

In Qatar the contract to provide Typhoon and Hawk aircraft along with a bespoke support and training package is progressing to plan.

In Oman we provide support to Typhoon and Hawk aircraft and naval vessels.

In Canada, BAE Systems is the design partner on the Canadian Surface Combatant programme of 15 ships for the Royal Canadian Navy. This long-term programme has now commenced and we are working on other prospects with the Canadian customer.

We have a strong presence in Sweden through BAE Systems Hägglunds supplying and supporting tracked vehicles for international customers.

In Turkey we are collaborating on the initial development phase of the indigenous fifth-generation fighter jet, TF-X, for the Turkish Air Force and we maintain our position in armoured combat vehicles through the FNSS joint venture.

In India, we have long-established relationships with local industry partners, Hindustan Aeronautics Limited on Hawk aircraft and Mahindra Defence Services Limited on M777 howitzers.

In Malaysia, we are a supplier to the armed forces, both directly and through joint ventures.

Our US businesses export combat vehicles and precision weapon systems to a number of international customers and leverage further international markets through our partnerships in defence and commercial electronics. The outlook in the Asia-Pacific region to further those export opportunities looks positive.

Through our shareholding in MBDA, our position in the missiles and missile systems market continues to grow in European domestic and other international markets. MBDA and the Eurofighter consortium look well placed to benefit from the expected European defence spending increases as a number of countries look to move nearer to their NATO commitments. Eurofighter partner nations Germany and Spain are considering future Typhoon orders and other Typhoon and support opportunities are being pursued in the Middle East and Europe.

Sales[1]

£4,257m

1. Revenue plus the Group's share of revenue of equity accounted investments.

How our business works

We help our customers stay a step ahead when protecting people, national security, critical infrastructure and vital information.

Our business model

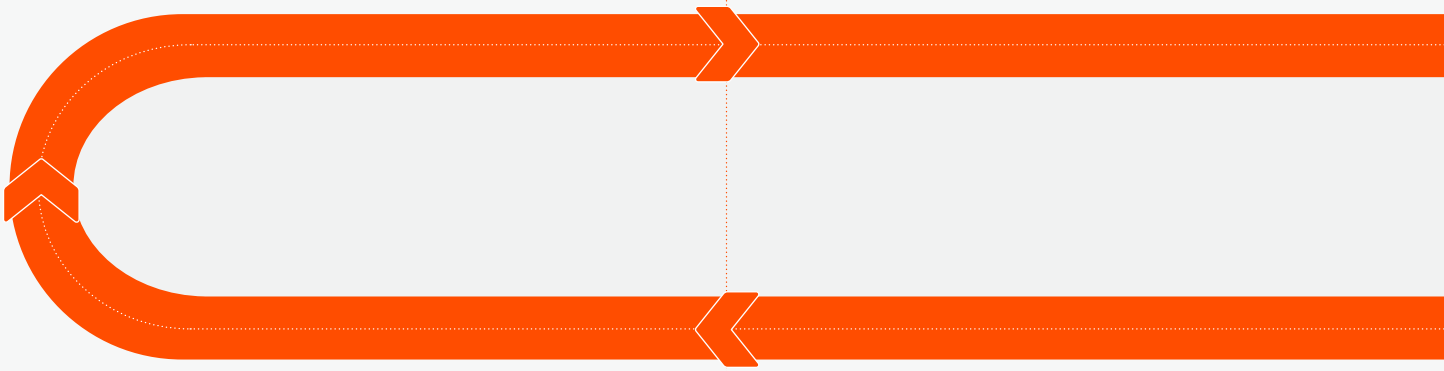
We aim to create sustainable value for all our stakeholders.

Identifying customer needs

- We have established positions on long-term programmes
- Strong and collaborative relationships with our customers
- Our position as a trusted supplier allows us to identify emerging trends and opportunities for growth

Research and development

- Technology and innovation underpin our strategy and the development of products and services
- Partner with academic and industrial leaders to develop new technologies that support our future product strategies
- Clear focus for our research and development spend and that of our customers aligned to future product strategies



Services, sustainment and upgrade

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

Advanced manufacturing, commissioning and integration

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

Our business model is underpinned by:

Our values

Our values of Trusted, Innovative and Bold and our Behaviours ensure our focus is on how we create value rather than simply how much money we make. Our people are empowered to make the right decisions and know where to go to seek help.

Our people

Our workplace culture rewards merit, values diversity and encourages everyone to be their best. We are committed to nurturing talent and developing highly-skilled people. We are training the next generation of engineers and business leaders to be able to drive innovation and solve complex challenges.

Our technology

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

Our partners and key relationships

We recognise the important contribution provided by our suppliers and partners and we maintain close relationships with them which help us to create best-in-class, cost-effective products and services.

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39 Our partners and key relationships

Non-financial information statement
The sections of the Strategic report entitled 'How our business works', 'Our stakeholders', 'Companies Act Section 172' and 'Sustainability' (pages 24 to 43), constitute the Non-Financial Statement as required by the Companies Act 2006 as amended.

Bidding and contracting

- Focus on value for our customers while effectively managing risk
- Record of delivery on complex projects
- Partnerships with a network of suppliers 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 manufacture and use of our products
- Products are designed and developed in a way that provides for future flexibility with the ability to upgrade in an agile manner

Responsible sourcing and impact

We take pride in managing our operations responsibly. We care for the places where we operate, we are committed to reducing our environmental impact and invest in technologies to reduce carbon emissions and water use.

40 Responsible sourcing and impact

Our governance framework

We are accountable for all that we do – our robust governance framework sets out how we do business. Together with our Code of Conduct, which requires our employees to conduct business in an ethical way, it enables us to earn and maintain the trust of our stakeholders.

84 Board governance

Generating sustainable value

Customers

Our largest customers are governments, but we also sell to large prime contractors and commercial businesses. We never lose sight of who the end users of our products and services are and we take on and solve some of their most complex and challenging engineering and technology projects to give them a competitive edge and help them to protect what matters most.

Employment

High-value jobs are supported by BAE Systems in the markets where we and our suppliers operate. We support jobs through direct employment, through the indirect impact of the employees employed as a result of our supply chain spending and through those jobs supported by the consumer spending of our employees and of those in our supply chain.

Contribution to local communities

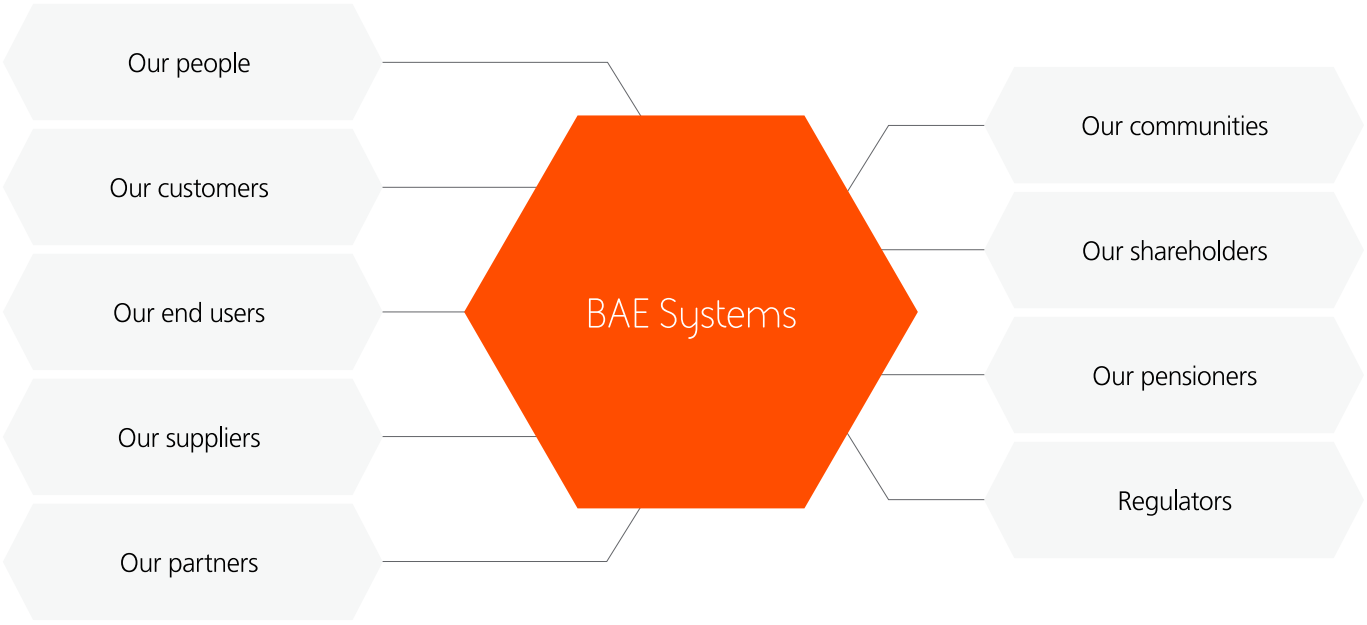
We take our role in communities seriously. We contribute to the economic prosperity of the places where our people live and work. Supporting causes that have meaning to our business and the communities in which we operate is vitally important to us and our employees.

Returns for shareholders

Through the careful long-term sustainable management of our business we will be well placed to continue to generate good returns for our shareholders.

Our stakeholders

Understanding and aiming to exceed the expectations of our stakeholders is critical to the long-term sustainability of our business and the vital role we play in helping our customers to protect people, information and nations.



Stakeholder group	Description	Areas of interest	Why we engage	How we engage
Our people	Employees of BAE Systems	– Ensuring our people can fulfil their potential at work – Recruitment – Training and development – Reward and recognition – Diversity and inclusion – How we work together	The skills, capabilities and commitment of our people are critical to ensuring the long-term sustainability of our business and delivering the innovation needed to solve our customers' complex challenges. Effective engagement enables our employees to contribute to improving business performance and helps us to create an environment in which everyone can fulfil their potential.	We keep employees informed about what is happening across the business using a variety of media, including our intranet, email and employee app, through podcasts, newsletters, leadership blogs and trade union forums, and also through leadership briefings and team meetings where we seek to listen to employees' views and opinions. Employees are encouraged to share their views through our channels and employee surveys. We also engage with trade unions in Australia and the UK and labour unions in the US.
Our customers	Large governments and their procurement bodies, large prime contractors and commercial businesses	– Value for money – Quality of products and services – Risk management – Timely delivery	Understanding our customers' needs and challenges is central to our product strategies and how and where we invest in technologies and infrastructure.	Through regular dialogue and face-to-face meetings, integrated project teams, joint reviews of programme performance, events and exhibitions.
Our end users	The men and women who use our products and services, often members of the Armed Forces and Security Services	– Quality of products and services – Reliability of our teams to rectify issues quickly	Our end users protect people, information and nations.	We work very closely with the men and women who use our products and services, in some instances our people work alongside them at their facilities or bases. We also engage through regular dialogue and face-to-face meetings.

Stakeholder group	Description	Areas of interest	Why we engage	How we engage
Our suppliers	The companies we work with to deliver products and services to our customers	– Labour and skills requirements – Cost of materials and operations – Terms of trade – Timely payment – Sustainable sourcing	Our suppliers and an effective, efficient and sustainable supply chain are essential to enable us to deliver for our customers and end users.	Through performance reviews, forums, regular dialogue and best practice sharing.
Our partners	Other industry companies or academic institutions who we work with	– Product and service development – R&D investment	We benefit from partnering with other organisations to leverage expertise or technology so that we can offer the best possible products and services to our customers.	Through regular dialogue and face-to-face meetings, forums and conferences and integrated project teams.
Our communities	The people who live where we work and charitable organisations we support	– The value we bring to the communities in which we operate – Employment – Local community factors	To ensure we maintain the trust of the communities where we work. To understand and respond to any issues important to our communities. To provide employment opportunities and contribute to the economic prosperity of the places where our people live and work.	Through community forums, volunteering and fundraising, STEM initiatives, Schools Roadshows and programmes such as Movement To Work.
Our shareholders	Investors who provide capital to the business	– Profitability, growth potential and cash generation – Capital allocation; returns via dividend and buyback – Operational performance – Quality of management – Governance, environmental and social policies – Share price performance	To ensure the owners of our shares and potential investors in the Company have a full understanding of our business including the strategy, growth potential and risks in the business as well as the overall performance of the business.	Through a regular dialogue with analysts and investors conducted through investor meetings and roadshows, capital market days, results presentations, Annual General Meeting, regulatory disclosures, our website and investor relations app.
Our pensioners	Members and trustees of our pension schemes	– Company performance – Member benefits – Pension fund investment strategy – Deficit recovery	To ensure our pensioners have access to all the information they need to manage their pension.	Through newsletters, our website and pensions contact centres.
Regulators	Bodies that supervise industry or business activities	– Industry or business policies and regulations	In order to have a constructive dialogue with those who impact the regulations which can influence our business.	Through regular dialogue and via trade associations.

We also engage with other organisations who have a focus on business or defence and security issues to understand factors that can impact our business and how we operate.

Companies Act Section 172

The directors of BAE Systems – and those of all UK companies – must act in accordance with a set of general duties. These include a duty under Section 172 of the Companies Act to promote the success of the Company and in doing so they must have regard (amongst other things) to the factors summarised below.

Typically, in large and complex companies such as BAE Systems, the directors fulfil their duties partly through a governance framework that delegates day-to-day decision-making to employees of the Company. The Board recognises that such delegation needs to be part of a robust governance structure, which covers: the values and behaviours expected of our employees; the standards that they must adhere to; how we engage with stakeholders; and how the Board assures itself that the governance structure and system of controls continue to be robust.

The following summarises how the directors had regard to the respective elements of Section 172 factors set out below in the fulfilment of their duties during 2019. More information on this can be found throughout this report, particularly in the sections highlighted.

The Board recognises that the Company has a range of stakeholders that it needs to have regard to when fulfilling its duties under Section 172. An analysis of its principal stakeholders can be found on pages 26 and 27.

Companies Act 2006, Section 172(1)

"A director of a company must act in the way, he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the following factors:

(a) the likely consequences of any decision in the long term;

(b) the interests of the company's employees;

(c) the need to foster the company's business relationships with suppliers, customers and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of business conduct; and

(f) the need to act fairly as between members of the company."

84 Board governance

Our approach	Examples of how we have had regard to this factor during the year

Long-term consequences of decisions

Developing strategy
The Board oversees a structured approach to the development of the Company's strategy, looking at commercial considerations and the development of current and possible future markets. It also takes a long-term perspective on matters such as possible geopolitical change, strategic workforce requirements and the impact of new technology. Long-term business planning and key strategic decisions are undertaken in line with the strategy agreed by the Board.

Research and development
Through the strategy development and business planning processes, the Board approves the level of R&D funding and priorities for such investment.

Bidding for new business
A significant part of our business involves complex, long-term programmes. The quality of the input and decision-making when bidding for such work is critical to our long-term performance, and ultimately our viability. Consequently, the Board oversees core business processes designed to ensure that, when we win new business, we are well placed to deliver on our commitments and deliver products and services that fully meet our customers' requirements and deliver an appropriate return. To ensure that proper judgement is exercised over bids, there are certain mandated levels of approval, with decisions on the largest bids being reserved ultimately for the Board.

Capital allocation
The Company's capital allocation policy, including its approach to the payment of dividends, has been agreed by the Board and ensures that key balance sheet-related decisions are made within a long-term policy structure.

People strategy
Our ability to deliver on our commitments to customers and sustain the business in the long term is highly dependent on the skills and know-how of our workforce. With new technologies emerging, we recognise that the balance and type of skills we require is changing. We are planning for the future by identifying the key skills we require and how we acquire these through the training and development of our existing workforce, and also by targeting and attracting new employees. Apprenticeship and graduate entry schemes are an important part of how we develop the highly-skilled workforce that is essential to our success. We are also focusing on generational changes in the workplace to create a productive environment for our future workforce. A key element for all our workplace activity is listening to our employees to understand what they value most in terms of the working environment and the development of their careers with BAE Systems.

Strategic actions
During its annual strategy review in November 2019, the Board identified further investment in our US Electronic Systems business as a strategic priority to help to support the long-term success of the Company. Towards the end of 2019, it became aware of an opportunity to acquire Collins Aerospace's Military Global Positioning System business and Raytheon's Airborne Tactical Radios business. The strategic planning work undertaken by the Board meant that it was well placed to understand the strong strategic and financial rationale for acquiring these businesses, and how they would further enhance the opportunity for continued growth in Electronic Systems. Following initial Board discussion and approvals in December 2019, it subsequently agreed the Company's bid that led to the recently announced proposed acquisition of these businesses.

In 2019, the Board agreed the proposed sale of our interest in a Saudi Arabian joint venture company, Advanced Electronics Company, to Saudi Arabian Military Industries, the Saudi Arabian national development and support holding company for local defence industries. The sale is expected to complete in 2020. This transaction will be an important step in the long-term strategic development of our Saudi Arabian support business.

During the year, we completed the strategic realignment of our Land UK business through the establishment of a joint venture, Rheinmetall BAE Systems Land (RBSL). One of the key factors in agreeing the RBSL joint venture was the need to sustain 450 jobs and retain key skills in the Land UK business. We anticipate that the combination of the two businesses will also help in accessing new business opportunities and thereby provide for potential growth in the UK workforce.

Investment in research and development
The Company has invested in R&D in line with the priorities agreed by the Board. Our US Electronic Systems business was the focus of much of this, as we invested to keep it at the forefront of capability in the areas of electronic warfare, precision-guided munitions, intelligence, surveillance and reconnaissance, and electro-optics.

In the UK, through the Tempest programme, we funded significant new R&D investment in the development of the cutting-edge technologies required for next-generation combat air systems.

Bids
The Board considered a number of major bids during the year and approved the terms on which these were submitted to potential customers. These included approval for the pricing of a major bid to be submitted by our Electronic Systems business for the production of electronic warfare sets for the F-35 programme.

Dividends
Consistent with its capital allocation policy, during the year the Board made decisions in respect of the 2018 final dividend and an interim dividend for 2019.

Strategic workforce planning
During the year, the Board reviewed the work being undertaken by our Human Resources function on strategic workforce planning, and how this was being used to determine future workforce requirements and particular skills needs. This work included an analysis of our success in retaining people and the perspective we have gained from our workforce engagement surveys on what their priorities are in terms of working practices and the career opportunities we provide. The Board welcomed the investment we continue to make in our outstanding UK apprenticeship programmes. In addition, the Board agreed proposals to revamp the UK graduate recruitment programme to ensure it is aligned with our future workforce requirements, and the launch of an early careers structure to complement the apprentice and graduate programmes.

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84 Board governance

Companies Act Section 172
continued

Our approach	Examples of how we have had regard to this factor during the year

The interest of Company employees

Our commitment to employees
We are committed to creating a culture where all our employees can give their best. Our Code of Conduct provides employees with guidance on matters such as the support we provide, respect for their rights within the workplace, and how issues and concerns are dealt with. The Board oversees the mechanisms we have in place to help to ensure employees can raise any matters of concern, and how such matters are considered and, where necessary, investigated.

Reward
Employees are provided with competitive reward packages that reflect their individual responsibilities and contribution to business performance. We also recognise individual and team successes.

Diversity and inclusion
We are committed to being an inclusive organisation with a diverse workforce that reflects the global communities in which we work. Our current priority is to ensure diversity and inclusion is embedded in the very core of our business, in our practices, policies, education and training to ensure that all of our employees are valued and respected and can thrive during their careers at BAE Systems. Our leaders are held accountable for making progress and each business owns and drives strategies in support of our priorities. Progress on our key priorities is monitored to assist the Board in tracking its progress.

Safety
The Board, through the Corporate Responsibility Committee, oversees our objective of driving towards world-class levels of safety performance.

Board employee engagement
As part of its annual programme, Directors regularly engage directly with Company employees. In 2019 this included visits to a number of sites including Norfolk, Radford and Endicott in the US, and Barrow, Glasgow and Stevenage in the UK. In 2018 the Board agreed that the Corporate Responsibility Committee would lead on engagement with the Company's workforce, with the aim of strengthening the employee voice in the boardroom.

Investing in jobs and skills
In 2019, the Board visited the recently opened Academy for Skills and Knowledge at our Barrow site in the UK. The Academy is a £25m investment to provide the engineering skills needed for the long-term success of our Submarines business. More than 1,500 employees use the facility each month, including the 700 apprentices employed in the business – some of whom met with the Directors during their visit.

Rewarding employees
The Remuneration Committee conducted an in-depth review of entire workforce remuneration and the alignment of incentives with the Company's culture. The review covered the structuring of pay and incentives across the Group. It also looked at how we are using eight future-focused behaviours to help to ensure that incentives and culture are aligned. These behaviours are aimed at strengthening and developing the attributes we need to succeed in the future, creating a positive, inclusive workplace for all employees.

The Remuneration Committee, on behalf of the Board, also oversees the operation of the Free Shares Plan, through which Group employees (other than those in the US, where other local reward/incentive plans apply) regularly receive awards of shares based on the Company's annual performance. Last year, in respect of 2018 performance, the Committee agreed an award to the value of £394 for all eligible employees, with over 3.4 million BAE Systems shares being awarded to 41,142 employees.

Alignment of incentives with employee interests
In determining the level of awards payable to Executive Directors and other senior executives under the Annual Incentive Plan, the Remuneration Committee reviews performance against the safety, and diversity and inclusion objectives.

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Our approach	Examples of how we have had regard to this factor during the year

Business relationships

Customers
The nature of our business means that we have a relatively small number of customers, with whom we typically enjoy high value, long-term relationships that are focused on the delivery of complex and technically challenging programmes. Senior operational leaders, including the Chief Executive, are responsible for managing the important relationships we have with our customers – engaging with them, providing visibility of our performance and responding to their requirements. Other Board members – particularly the Chairman – also engage directly with customers, which helps to develop relationships and ensure the customer voice is heard in the boardroom.

Suppliers
The Company looks to work with suppliers that embrace standards of ethical behaviour that are consistent with our own. To clarify what we expect from our suppliers and their supply chains, we developed our Supplier Principles – Guidance for Responsible Business, which reflect the standards we set for ourselves. The Principles outline a set of 'best practice' expectations, based on our Code of Conduct, The United Nations Declaration of Human Rights, International Labour Organisation Conventions, and national laws and regulations that apply. They also contain information included within International Forum on Business Ethical Conduct's Supply Chain Code of Conduct and reinforce our stance on responsible procurement. We are committed to conducting business responsibly and to maintaining and improving systems and processes to reduce the risk of slavery or human trafficking in our business or supply chain.

We work with suppliers and their supply chains to provide fully-compliant, cost-effective goods, services and solutions. Our supplier relationships are often long-term due to the length of our product lifecycles, therefore we aim to work with suppliers who share our values and who embrace standards of ethical behaviour consistent with our own.

The Board received a report from the Group Finance Director on the performance of the Company's largest UK subsidiaries relative to the requirements of the UK government's Prompt Payment Code. This included details of the actions being taken to address a deterioration in performance by certain subsidiaries compared with previous years. The Board will continue to monitor performance in this area.

Programme delivery
Delivering on the commitments we make to our customers is critical to our long-term success. During 2019 the Board's oversight of performance focused on how best to ensure that major new programmes, such as Type 26 frigate and the associated Australian and Canadian contracts, are resourced and can meet programme milestones agreed with customers. As part of this, we recognised learning opportunities from some of the challenges and successes we have had on new US combat vehicle and electronic systems programmes.

During the year, Board members spent time understanding more about the UK government's Future Combat Air Strategy and Team Tempest, and how we continue to develop our relationship with the customer on a programme that is of strategic importance to our UK Air business. This partnership illustrates how we work closely with key customers to understand and anticipate their future needs, which is critical to the investment decisions we make in developing and acquiring new technology and capabilities.

Customer satisfaction
Our defence customers are typically national governments or other major defence contractors for whom we are a significant supplier. At Board level, the Chief Executive and the President and Chief Executive Officer of our US business meet regularly with customers and, as necessary, subsequently brief the Board on the status of these important relationships and how we are delivering on our commitments. During the year, the Board was also provided with details of the output from our customer satisfaction process, as managed by our Group Business Development function.

Suppliers
During the year the Board met with senior leaders from our Procurement function to review the work they are doing in working with our suppliers to ensure we procure goods and services on a cost-effective basis, and consistent with mutually-agreed quality and delivery requirements. The Board was supportive of the strategic actions being taken to develop long-term relationships with key suppliers on major contracts, including those for our international anti-submarine frigate programmes and the Tempest future combat air programme. Such activity is mutually beneficial. For suppliers, this can be the basis of enduring relationships that allow them to invest for the long term, and for us, this reduces our critical supplier risks, assists in the development of new capability and reduces costs.

39 Our partners

Companies Act Section 172
continued

Our approach	Examples of how we have had regard to this factor during the year

Impact on community and environment

Community
We proactively consider, manage and review the impact we have on our local communities as part of the delivery of long-term sustainable business performance. The programmes we support are closely aligned with our business, from work with charities which support armed forces personnel and their families, to promoting the study of Science, Technology, Engineering and Mathematics.

Graduates and apprentices are vital to the continued success of our business and we invest in all of our early careers schemes, sustaining and developing new skills. As part of our continued commitment to nurture talent and develop high-end skills for the future, we recruited over 700 apprentices and almost 250 graduates in the UK in 2019.

Environment
As a major manufacturer, we recognise that our operations have an environmental impact – from the energy and resources used in operations, to the waste generated. We are committed to reducing the environmental impact of our operations and products, minimising our ecological footprint and in turn, decreasing our operational costs. The Board's Corporate Responsibility Committee provides oversight of our environmental commitments.

Community
During the year the Board visited the Company's site in Barrow-in-Furness, the centre of our Submarines business. As part of the visit, the Board engaged with local management to understand the importance of the local community to the long-term sustainability of that business. As a major employer in the region, being able to access the necessary skills is vital to our success and we are actively involved in supporting local education and training initiatives.

During the Board's time in Barrow it visited the recently-opened Academy for Skills and Knowledge, the second such establishment created by the Company in the UK in recent years. The directors had the opportunity to meet and engage with some of our apprentices and experience this state-of-the-art £25m training academy at first hand.

Environment
Ecological sustainability remained firmly on the 2019 agenda, with the Board visiting our site in Endicott, New York to develop its understanding of our electric and hybrid power and propulsion systems business and how our products are helping to achieve more sustainable transport solutions.

38 Our values
39 Responsible sourcing and impact

Reputation for high standards of business conduct

Values
Our business is underpinned by our Values – Trusted, Innovative and Bold. Together these values describe who we are and who we strive to be – they inform our decision-making and define our shared culture.

Responsible trading
Responsible business conduct is fundamental to the long-term success of the Company. We do not compromise on the way we conduct business and consistency of this approach is key to defining the Company reputation. Set out in our Operational Framework, we have four Responsible Trading Principles that underpin all of our business activity, they are:

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

Code of Conduct
Responsible behaviour is fundamental to how we do business. It is not just about what we do but how we do it that is vitally important to both the reputation and success of our Company. Our Code of Conduct sets out the standards and behaviours expected of all our employees, and details the guidance and support that we provide to help employees to meet the high standards of business conduct – legally and ethically – that our customers and other stakeholders expect.

Speaking up
We are committed to building a responsible culture where employees can speak up if they have questions or concerns. To assist with this, all employees have access to our 24-hour Ethics Helpline and an identified local Ethics Officer.

The right behaviours
During the year the Board considered the Company's culture and its alignment with our values. As part of this the Board welcomed the adoption of eight future-focused behaviours – Creativity, Adaptability, Collaboration, Develop People, Integrity, Courage, Inspiration and Strategic Vision – that will help ensure that we are focused both on what we do and how we do it. These are the behaviours we are looking to see demonstrated, advocated and embedded across the Company, and our leadership, workforce engagement and incentive processes are being aligned to help to achieve this.

Product Trading Policy
The Board's Corporate Responsibility Committee reviewed the application of our Product Trading Policy during 2019, looking at a specific key export market and understanding how policy requirements had been applied from the initial identification of a business winning opportunity, through to contract award and the establishment of local support and compliance infrastructure.

Advisers Policy
The Company engages third parties to provide advice on sales and marketing, the strategic aims and the political context of its business. Our Advisers Policy governs the appointment, payment and management of such parties. Recognising the risks associated with this activity, the Corporate Responsibility Committee regularly reviews the operation of this Policy and the associated compliance arrangements. During 2019, the Committee undertook such a review, which covered details of all adviser appointments and an overview of compliance activity.

Ethics Helpline and ethics monitors
During 2019 the Board reviewed how employees are encouraged to seek guidance, raise concerns or report issues, if necessary to an Ethics Officer or to the Ethics Helpline. We have appointed and trained over 160 Ethics Officers covering all our businesses. Where necessary, matters raised with these officers and through our Ethics Helpline are investigated using expertise available through the Company's Legal, Audit and HR functions. In addition, we are developing and rolling-out support mechanisms for employees affected by matters dealt with through these ethics processes.

38 Our values

Our approach	Examples of how we have had regard to this factor during the year

Acting fairly between members of the Company

Shareholder engagement
The Directors understand their duty to act fairly between different shareholders as required by UK company law and the Company's regulatory obligations pursuant to its UK listing.

Investor meetings and engagement
Shareholder contact is the responsibility of the executive directors and the Investor Relations team who manage and develop the Group's external relationships with institutional investors, prospective investors and analysts. They conduct a comprehensive programme of investor meetings, webcasts, conferences, industry events and calls, particularly following the release of annual and half-year results, and trading updates.

Investor Capital Market Days
In 2019, institutional investors and analysts were invited to our Warton facility in the UK for a site visit and briefing on the Air business, our largest sector.

Board engagement and investor feedback
The views of analysts and major investors are fed back to the Board on a regular basis, especially following roadshows; and Investor Relations regularly circulates updates to the Board.

A formal investor perception study conducted by an independent corporate advisory firm on major investor views, share price performance, the share register, and the investor relations programme is conducted every other year. This allows the Board to monitor performance and increase focus in certain areas.

The Chairman holds individual shareholder meetings during the year with major investors, and he and other non-executive directors are available to attend meetings with major shareholders at the request of either party to gain an understanding of any issues and concerns.

The Remuneration Committee Chairman writes to and consults with major shareholders and voting agencies annually on proposals regarding executive remuneration.

Brad Greve, Group Finance Director designate, has met key shareholders as part of his induction.

Annual General Meeting
The AGM provides an important opportunity for our shareholders to participate in the governance of the Company and for the Board to engage and communicate with private and institutional investors.

The meeting also provides all shareholders with the opportunity to vote on the resolutions put to them either electronically via the Company's website, by post or in person at the meeting. All resolutions detailed in the Notice of Meeting are voted on by way of a poll so as to ensure that all votes are counted on the basis of one vote for every share held. The results of the voting on all resolutions are published on the Company's website.

28 Directors' duties
84 Board governance

Sustainability

We are a business that operates responsibly and with integrity, supporting performance by managing both current and future risks and opportunities.

We are one of the world's largest defence and security companies. Our global footprint and wide range of products and services means that our markets are subject to significant shifts and challenges in geopolitics; public spending and security priorities; and engineering and cyber technology. We monitor and respond to these changes as part of our business operations.



Our approach to UN Sustainable Development Goals

We recognise the importance of sustainable development in ensuring that we can operate, compete and effectively manage current and future business opportunities alongside understanding our impact on the wider community.

The UN Sustainable Development Goals (SDGs) provide a framework for development and address the challenges that the global population faces from tackling climate change and environmental risks through to managing societal needs and building economic growth. Together the goals also contribute substantially to the realisation of human rights.

We recognise that we can make a valuable contribution towards the SDGs which we are able to influence.

Our current sustainability agenda supports the following SDGs:

3. Good health and well-being
4. Quality education
5. Gender equality
8. Decent work and economic growth
12. Responsible consumption and production
13. Climate action
16. Peace, justice and strong institutions
17. Partnerships for the goals

2020 priorities

During 2020, we will be undertaking a formal review of our Environmental, Social and Governance risks including climate-related risks, and engaging with stakeholders on our sustainability approach, to ensure our agenda and priorities remain relevant and informed by a wide range of views.

Sustainability agenda

Our sustainability agenda is fundamental to the success of our business. It supports our global business and provides a framework on how we do business. It is driven from the top with input from a wide range of stakeholders. When we think about what is material we consider how our approach to sustainability will drive success, contribute to our wider communities and reduce our impact on the environment.

The following priorities are considered and managed as part of our sustainability agenda:

- **People** – our ability to deliver against our strategy is dependent on recruiting and retaining people with appropriate talent and skills;
- **Safety and wellbeing** – ensuring a safe and constructive working environment is a fundamental responsibility;
- **Ethics and business conduct** – our licence to trade is dependent upon adherence to our policies and high standards of conduct and behaviour;
- **Responsible supply chain** – our responsibilities and ability to operate require a sustainable supply chain. We also recognise the potential risks associated with an extensive supplier network, such as modern slavery and human trafficking;
- **Human rights** – we are committed to respecting human rights. This applies equally to our employees, our suppliers and business partners;
- **Environment and climate change** – the risk that climate change will have a significant and lasting impact on economic growth and prosperity is a factor that all companies need to recognise and respond to;
- **Community** – supporting causes that have meaning to our business and the communities in which we operate is important to us; and
- **Investment in technology and research and development** – technology and innovation underpin our strategy and the development of our products and services.

Robust governance remains at the core of our business as detailed in the Governance section on pages 82 to 156 and underpins the sustainability of the business.

76 How we manage risk

78 Our principal risks

Whilst robust governance remains at the core of our business, we recognise the long-term sustainability of our business is also dependent on us managing the environmental and social impacts of our business.

Creating an inspiring and inclusive workplace for our people

It is through the diverse talent, skills and commitment of our employees that we are able to take on and solve some of our customers' most complex and demanding engineering and technology challenges. We strive to create an inclusive workplace in which all our employees give their best for our customers and are recognised and rewarded for their contribution.

Our People strategy

Our People strategy sets out how we inspire and develop high-performing teams and individuals, able to fulfil their potential in an inclusive and supportive working environment.

Our People Policy lays the foundations, setting out our people management expectations, including in relation to diversity and inclusion, training and development, reward, and employee engagement.

Our Group Human Resources (HR) Director reports directly to the Chief Executive and chairs the Global HR Council, ensuring our People strategy supports the Integrated Business Plan and People Policy to meet the needs of our business and our customers.

Our approach

Recognising that our ways of working are critical to achieving our strategic priorities, we have increased our focus on assessing and rewarding both what our people achieve, and how they achieve it.

During 2019, we introduced a set of Company Behaviours to define how we want to work together and with our stakeholders, encouraging attributes such as collaboration, innovation, creativity and adaptability that will underpin personal, team and organisational success. Together, the behaviours and our shared strategic objectives give clarity on what is expected and how we can work together to deliver our strategy and achieve our potential.

Our focus on performance has strengthened our ability to identify and develop people and key skills across the Group, to help us to build a strong, diverse pipeline of talent to fulfil our future needs. In 2019 we introduced an enhanced talent management and succession planning process, featuring talent reviews with the Chief Executive, to ensure we have broad and consistent visibility of our talent across the Group. This is enabling more targeted development and career planning, greater mobility and effective succession planning.

Our refreshed approach to global mobility is supporting a greater number of our people in growing their capabilities and careers through experience of our international operations. The number of employees on international assignment increased by about 12% in 2019 and employees' positive feedback on their experience increased by around 10%.

Our business is dependent on our ability to recruit and retain a wide range of people with the appropriate talent and skills to deliver excellence to our customers, including engineers, designers, software developers and project managers, and we have identified this as a principal risk (see page 81). We are building strategic workforce planning into our Integrated Business Planning processes to ensure our plans take account of the people, skills, technology and facilities we will need to deliver our future plans.

We encourage all employees to evolve their skills to meet our customers' current and future requirements, supporting them through career frameworks, online and face-to-face training and development programmes.

We look to draw people from a wide range of backgrounds to bring diversity of experience and thinking to our teams. We offer award-winning apprenticeship and graduate programmes to bring fresh talent into our business and help individuals develop skills for a fulfilling career. In 2019 we recruited over 700 apprentices in the UK – one of our highest intakes in recent years. We have 500 graduate scheme members in the UK and 68 undergraduate students on a 12-month industrial placement, and in 2019, we hosted 140 summer interns. In the US we supported 773 intern positions in 2019 and had 90 participants in the US apprenticeship programme, resulting in 43 full-time hires.

In the US we recruit diverse talent from top universities to join our functional leadership development programmes in areas such as engineering, manufacturing and finance. These programmes are designed to provide the training and rotational experiences needed to keep our early-career talent engaged and our most mission-critical functions strong.

In 2019, 42% of our global hires (over 4,000 positions) were into Science, Technology, Engineering and Maths (STEM) roles. In our US business we hired 392 college graduates, and 83% of these college hires were in STEM roles.

To help to mitigate the STEM skills shortage and increase the diversity of the pipeline of STEM talent in our major markets, we continue our commitment to engaging children and young adults in STEM subjects and careers. In the UK, we reached over 100,000 students and young people in 2019 through a range of STEM outreach programmes and sponsorships.

In the US, we continue to sponsor championship events with FIRST Robotics, engaging young people in exciting, mentor-based programmes that build STEM skills, inspire innovation and develop communication and leadership skills. In addition, the US business continued to invest in the National Math and Science Initiative including its College Readiness Program, to support more consistent access to high-quality education for students of military families.

We have further strengthened our commitment to diversity and inclusion through clear, common objectives focused on attracting and retaining a diverse workforce that reflects market availability at all levels of the organisation, and advancing an inclusive workplace where employees feel that their differences are valued and intentionally leveraged.

Our leaders are held accountable for progress against these objectives through local targets, measured through robust data analysis of the demographic profile of our workforce.

In 2019, our leaders were active in role-modelling inclusion and supporting diversity celebrations, initiatives and events, in addition to embedding inclusive leadership as an everyday habit.

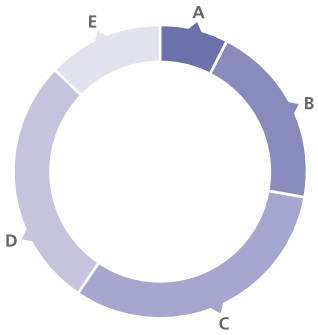
We actively encourage and support the development of Employee Resource Groups (ERGs) to foster a diverse and inclusive workforce. Our ERGs include: Gender (UK, US, KSA and Australia), Veterans (US), Disability (UK, US and KSA), Race (UK and US), LGBTQ+ (UK and US) plus Hispanic/Latino, Black/African American and inter-generational ERGs in the US.

We understand that people perform at their best when they feel engaged with the work they do and who they are doing it for, and feel fairly rewarded for their contribution.

Gender diversity

	Male	Female
Board	8 (67%)	4 (33%)
Senior managers[1,2]	306 (82%)	69 (18%)
Total employees[3,4]	62,000 (78%)	17,000 (22%)

Age diversity[3,4]



A	24 years and younger	6,000
B	25–34 years	16,000
C	35–49 years	25,000
D	50–59 years	22,000
E	60 years and older	10,000

We keep our employees informed and engaged through our intranet and employee app, email, podcasts, newsletters, leadership blogs and briefings, and through our line managers who help to connect everyone's daily work to our mission.

We have a range of policies in place to support employees to achieve balance between their work commitments and personal priorities including Maternity, Paternity, Adoption and Shared Parental Leave policies, agile and flexible working practices and career breaks.

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 through a variety of financial and non-financial recognition schemes across the organisation. We also offer post-retirement benefit plans aligned to competitive practice in each relevant home market. We encourage employees to become shareholders in BAE Systems and, in some markets, offer share schemes to support this.

2020 priorities

- Support business objectives by fulfilling record recruitment numbers in some of our major markets through efficient and effective recruitment processes.
- Build and maintain a robust pipeline of talent and critical skills to fulfil our customers' future requirements, through ongoing focus on training, development, performance management and succession planning.
- Build on our organisational strengths by embedding our Company Behaviours into our recruitment, performance, reward and recognition practices.
- Increase the diversity of our workforce and continue to build diversity and inclusion into our processes, practices, policies, systems and training.
- Further embed strategic workforce planning to inform medium- and long-term business decision-making.

Gender pay gap

We have published our third annual gender pay gap report in line with UK regulations. For 2019, the average gender pay gap for our UK workforce was 10.3% (2018 9.0%), which is lower than the current UK national average of 17.3%. We have a gender pay gap because we employ around four times more men than women and a greater proportion of our senior leadership population is male. We rely on employing large numbers of employees with STEM qualifications and we, like other companies, face challenges recruiting females with these qualifications because there are significantly fewer women who study and work in these fields. We are working hard to improve our gender balance and to increase the number of women in senior executive positions and in engineering roles.

Trade unions/labour unions

We seek to maintain constructive relationships with trade unions in Australia and the UK and labour unions in the US. Of our UK workforce, 69% are covered by collective bargaining agreements and approximately 55% of the UK workforce are trade union members. In the US approximately 11% of the workforce is covered by a collective bargaining agreement. In the UK, we have excellent relationships with the main organisations involved and organise regular meetings through our Corporate Trade Union Consultation Council. We have structures in place to work with trade union representatives in our local markets, where it is appropriate and legally acceptable.



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. BAE Systems Internal Audit has reviewed and confirmed effective systems, processes and controls are in place to collate and validate this data.

Safety and wellbeing

The safety and wellbeing of our employees is paramount. Operationally our safety performance in the year fell below our high expectations. To that end, we have sought external expertise to review a number of our sites and strengthened our team with new heads of safety in the UK and US to re-focus and sharpen our thinking in this critical area.

Many of our people work in challenging environments and on some of the most complex engineering projects.

Risks to the safety of our employees are many and varied across the Group. They include slips, trips and falls, work in confined spaces, machinery operation and explosion risks associated with the manufacture of munitions, amongst others. We monitor and aim to eliminate, mitigate or manage all risks, where possible. Our approach to identifying and assessing safety risks is embedded within our approach to risk management (see page 76).

We strive for world-class safety conditions; our management of this area is necessarily strong and tailored towards achieving a world-class standard. We work hard to create a working environment which contributes to employee physical and mental wellbeing. It is our collective focus on employee wellbeing and the health and safety of employees and those who work on, or visit, our sites that is a contributory factor to the success of our organisation. We have a range of programmes focused on this. Where there are identified hazards, we provide employees exposed to these with protective equipment and regular monitoring, which allows us to understand their working environment and make it as safe as possible.

Our policies detail expectations of all our employees, driving continual improvement in safety standards. We employ teams of specialists to understand and mitigate safety risks, and, at a senior level, part of the executive bonus structure is aligned to meeting specific safety key performance indicators.

Our wellbeing programmes include policies to support employees in balancing their work and personal responsibilities. It is especially important to us that we support wider issues that our employees may face in their daily lives, and our Employee Assistance Programme provides assistance to employees across a range of issues, including mental and financial wellbeing. Assistance comes in the form of face-to-face and telephone counselling. We are progressively introducing mental health awareness and mental health first aider training to support our employees.

To ensure an improving safety culture and to incentivise leadership in this area, the Board continues to prioritise safety in the business through the inclusion of a specific safety objective that is designed to be realistic, but stretching.

Performance against the safety element of the executive bonus is 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 a reduction in recordable accidents.

Line managers are also incentivised to achieve the desired safety culture and additional personal objectives are identified through the Performance Development Review process.

We use the Recordable Accident Rate as a key performance indicator to assess workplace safety improvements. This metric, along with the number of major injuries and progress on culture and risk reduction, is used to determine an element of executive bonus. During 2019, our Recordable Accident Rate did not meet our 10% reduction target. Our US business, however, did meet the stretch target, with an improvement of 16%, but this was offset by the deterioration in performance in some parts of our Air sector and in our UK Maritime businesses. Major injuries also showed a small deterioration across the UK in particular. The health and safety of our employees continues to be our highest priority and a number of improvement actions and measures have been put in place to rectify the 2019 performance.

The portion of executive bonus associated with safety performance has been assigned accordingly with the US receiving a payout commensurate with a strong performance and those parts of our Maritime and Air businesses who did not meet target receiving zero. At Group level, a small part of the available award was made in recognition of strong performances in the US.

2020 priorities

During 2020 we will aim to:

- reduce the overall significant safety risk rating;
- drive improvements in behavioural safety; and
- demonstrate improvements against key safety indicators.

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

BONUS KPI



Major injuries recorded[1]

BONUS



BONUS

3% of the UK executive directors' bonuses are based on the achievement of safety KPIs (see page 122).

1. BAE Systems Internal Audit has reviewed and confirmed effective systems, processes and controls are in place to collate and validate this data.

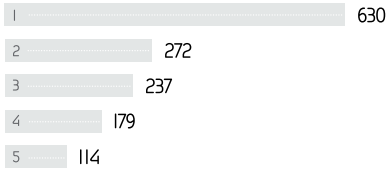
Total ethics enquiries[1]



Anonymity rate

35% (2018 28%)

2019 ethics enquiries by type[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]



Ethics and business conduct

Our success depends on us being trusted by all our stakeholders to uphold high standards of business conduct.

We have a zero-tolerance policy regarding bribery and corruption in all its forms. Our anti-corruption programme guides and supports our employees in making responsible decisions. It is designed to ensure adherence to the relevant legal and regulatory requirements recognising the bribery and corruption risks faced by the Company. It also helps employees to understand what is expected of them and to create an environment in which employees feel they can ask questions and raise issues and concerns.

This is embedded in our governance framework which outlines a set of operational standards that apply everywhere we operate. It is embedded through our key global policies and processes, including:

- **Advisers Policy** – which governs the appointment, management and payment of third parties who are engaged to assist with our sales and marketing activities or the strategic development of the Group;
- **Gifts and Hospitality Policy** – which governs the offering, giving or receiving of gifts or hospitality;
- **Conflict of Interest Policy** – designed to ensure that personal conflicts of interest do not impair employees' judgement and damage the Group's integrity and interests; and
- **Facilitation Payments Policy** – designed to ensure that facilitation payments are not paid and that the Group and its employees seek to eliminate the practice of facilitation payments.

Other policies include our Finance Policy, Fraud Prevention Policy, Export Control Policy, Lobbying, Political Donations and Other Political Activity Policy, Offset Policy and Procurement Policy, which include measures to address bribery and corruption risks.

The programme receives both internal and external oversight and assurance. Risk-based due diligence procedures have been implemented to address bribery, corruption and other financial and non-financial risk, and our policies include processes for risk-based internal and external approvals, ongoing monitoring and repeat due diligence. We drive improvements in the programme annually to ensure it continues to meet best practice.

The programme also includes our Code of Conduct and training which covers scenarios our employees may face, defines the standards and behaviours we aspire to every day and gives guidance on where to go for further advice. All employees are required to complete training annually. During 2019, 97% of our employees completed this training, with the majority of those who did not complete being employees on secondment, maternity leave, sick leave or other long-term absence. These employees will complete the training in due course on their return to the business.

We collect data on ethics enquiries and dismissals for reasons relating to unethical behaviour (see opposite). In 2019 there were 1,432 ethics enquiries, an increase of 11% on 2018. This trend is mostly driven from our US business, which has continued to encourage people to speak up and is maintaining communications to remind employees of the methods for making contact.

Our Code of Conduct training actively encourages all employees to speak up if they have a concern or talk to someone if they need guidance. We recommend employees talk to a colleague, their manager, HR or a Legal contact. We also actively promote our Ethics Officers and Ethics Helpline across our businesses, which means employees can raise issues or seek guidance in person and in confidence.

Our 2019 anonymity rate of 35% compares favourably with international benchmarks. It has increased since prior years, driven by a rise in the use of our helpline in the US to anonymously report low-risk concerns. We welcome all use of our helpline.

Our overall number of dismissals increased to 257 in 2019, due to an increase in the BAE Systems, Inc. business. The reason for this increase is due to policy changes that reflect an emphasis on respect in the workplace.

For the principal risks relating to compliance with anti-bribery and anti-corruption regulations and how the risk is mitigated, see the laws and regulations risk description on page 80.

Customers' requirements and expectations

The defence industry is subject to strict regulatory controls. We maintain stringent internal controls that govern what we sell and to whom. Our Product Trading Policy and Responsible Trading Principles help us to make informed decisions about the business opportunities we pursue based on our values.

1. BAE Systems Internal Audit has reviewed and confirmed effective systems, processes and controls are in place to collate and validate this data.

Export of controlled goods must be authorised by governments before a transfer can proceed. Failure to comply with all relevant laws and regulations could result in serious penalties for BAE Systems and the individuals concerned and could harm national security and foreign policy interests. Our Export Control Policy and Procedures are designed to ensure compliance with relevant regulations, as well as to detect and provide timely responses to actual or suspected violations, including prompt investigations and appropriate remedial actions.

2020 priorities
During 2020, we will review and update our Code of Conduct.

Responsible supply chain
We create best-in-class products and services through extensive collaboration with more than 22,000 suppliers worldwide. During 2019, we spent over £11bn across the world with directly-contracted suppliers. These relationships are usually long-lasting due to the complex nature of our products and their long lifecycles.

We aim to ensure that those we work with follow the same strict ethical standards that we place on ourselves. A large part of our business relies on relationships and partnerships with others, whether it be a strategic adviser, a supplier or a joint venture partner. In order to do business ethically, how our third parties behave is of the utmost importance.

We have policies in place which detail how we work with advisers and our expectations of them. Our supply chain management processes are comprehensive, focused on high achievement of our standards as well as practising a partnership approach with regard to community and social issues. Our joint venture arrangements are set out at the start of the venture to enhance our working relationships over the long term.

Risk-based due diligence is undertaken for all third parties with whom we engage, whether supplier, adviser, potential joint venture partner, acquisition target or other third party. Where required, this can include establishing the identity of the third party in terms of beneficial ownership and gathering of sufficient information to assess relevant bribery and corruption risks. At the contracting stage we ensure that contracts contain appropriate anti-corruption and anti-bribery provisions and stipulate the expectation to comply with our standards on ethical business conduct, compliance, safety, environmental management and human rights.

Once a supplier has been approved and a contract has been signed, we conduct further due diligence annually as a minimum or where there is a significant change in our relationship with the supplier. Suppliers are actively managed and monitored throughout the life of their contract.

To clarify what we expect from our suppliers and their supply chains we have developed the Supplier Principles – Guidance for Responsible Business (the Principles), which reflect the standards we set for our Board and employees.

The Principles specify compliance with all relevant national and international laws and include matters such as anti-corruption behaviours, environmental issues, responsible payment, conflict minerals and how employees are treated.

We use the Principles as a risk management framework to assess new suppliers. They are also used as an integral part of our supplier evaluation, due diligence, request for information, request for proposal, pre-qualification, selection and approval processes.

During 2019, we undertook supply chain assurance activity to assess compliance with our Supplier Principles and the UK Modern Slavery Act. Our assessments covered 10% of global spend. 12 low-level risks were identified and resolved. We also held supplier events across our business to facilitate best practice sharing and champion the sustainability agenda.

It is important to us that we work with our suppliers to deliver aspects of our sustainability agenda. A key area of focus is the development and education of the current and future workforce, and we encourage our suppliers to be involved with apprenticeship schemes and other career development programmes. Two areas of focus where we work in partnership with our suppliers in the UK are:

- supporting our supply chain in engaging with and inspiring the next generation within the education system by utilising a STEM How to Guide that was created by BAE Systems and the Women's Business Council. The guide targets Small and Medium Enterprises to provide the links and resources for them to become STEM ambassadors and deliver activities working with schools and youth groups; and
- reaching out to the individuals (16-24) who are not in education, employment or training by utilising the Movement to Work programme. This programme provides high-quality work training opportunities, including vocational training, mentoring and on-the-job experience, linking placements where possible to jobs or apprenticeships to create sustainable employment. In 2019, 90 people completed placements within our UK businesses, with nearly 80% of them going on to secure employment or further/higher education.

2020 priorities
During 2020, we will aim to:

- review and update our Supplier Principles – Guidance for Responsible Business;
- extend coverage of Supplier Principles assurance; and
- continue to assess our business partners and suppliers on the adoption of our Supplier Principles and compliance with the UK Modern Slavery Act.

Human rights
We are committed to respecting human rights wherever we operate, within our sphere of influence. This applies equally to our employees, our suppliers and business partners, all of whom are expected to adopt the same or similarly high standards of ethical behaviour. We are committed to conducting business responsibly and to maintaining and improving systems and processes to reduce the risk of slavery and human trafficking in our business or supply chain.

Our Code of Conduct and other global policies and processes mandated under the Operational Framework, together with our supporting principles and guidance on responsible trading and suppliers, support our commitment to human rights and are regularly reviewed. This results, for example, in due diligence being carried out during the supplier evaluation stage against non-financial risks, including human rights, working hours, harassment and unlawful discrimination, anti-whistleblowing, slavery, human trafficking and child labour.

Suppliers are regularly reviewed throughout their contractual relationships against such non-financial risks. In 2019, we published our response to the UK Modern Slavery Act and a statement in response to the California Transparency in Supply Chain Act on our website.

Our approach to identifying and assessing human rights risks is embedded within our approach to risk management (see page 76).

Environment and climate change

Responsibility for environmental issues sits with our Chief Executive. He is the owner of our Environmental Policy which details our commitment to addressing environmental impacts related to our products and activities, including climate change.

He is supported by the Board and Corporate Responsibility Committee in ensuring that an appropriate environmental programme and performance objectives are set and flowed down across the business. These objectives are intended to mitigate the Group's environmental impact, including in relation to climate change, in the immediate and long term, to enable the Group to deliver against its environmental commitments within its business model. The Corporate Responsibility Committee monitors progress in this area.

As a major manufacturer, we recognise that all of our operations have an impact on the environment, from the energy and resources we use, to the products we manufacture and the waste we generate. We are committed to high standards of environmental management and undertake activities with the aim of reducing the environmental impact of our operations, products and supply chain. Such activities range from considering resource use on sites; to finding energy efficiencies in the design of major platforms; to controlling and reducing hazardous materials in the supply chain. Some of these activities aid in the reduction of greenhouse gas emissions that BAE Systems produces and, in turn, contribute towards mitigating climate change globally.

Emerging environmental risk is considered and managed. Examples of this include an internal task force on Registration, Evaluation, Authorisation and Restriction of Chemicals, potential operating considerations for materials within our products and plans to move to 60% sourcing of renewable energy across the UK estate.

On a short-term basis, an inherent risk for our business, driven by changes in regulation, is carbon taxes, particularly the Climate Change Levy which applies to our UK operations. Although the magnitude of this risk has been assessed to be relatively low, it will have a direct impact on our operational costs.

Due to the long lifecycle of our products, we have to be aware of the long-term risks to our business and products, inclusive of environmental factors such as climate change. One key long-term risk that we have identified relates to extreme weather events (which may be increasing as a result of climate change). Extreme weather events, primarily flood risks, have the potential to directly impact our operations and, in turn, programme schedules.

Other direct environmental risks include:

- breaches of environmental requirements resulting in fines and/or the termination of permits;
- advancing technology and innovation;
- changes in regulatory requirements; and
- social and political change, differing legislation and policy in our various markets.

Indirect environmental risk includes the impact of use of products by customers and supply chain risk.

Our Environmental Policy mandates that we have an environmental management system (EMS) in place for all of our businesses. Short- and long-term risks outlined above are built into business EMS systems. Part of the EMS process is to define issues and set appropriate targets for the reduction of environmental impacts and risks.

We also take account of the opportunities associated with climate change. These include ways in which we can use our advanced engineering capabilities to develop new products and services that support low carbon or reduced emissions requirements. An example of this is the development of selective catalytic reduction technologies and hybrid propulsion systems.

Our approach to environmental targets

Environmental issues are by their nature global, and we are committed as a business to tackling these global issues, such as water scarcity, flooding, the contribution of greenhouse gas (GHG) emissions to climate change, and waste or effluent affecting the quality of our inland or sea waters.

The profile of our business, with large-scale projects and fluctuations in orders, makes it challenging to set a global emissions reduction target. Each year, we set energy targets at business level that contribute to an overall reduction. It is with this locally-tailored approach that we drive energy efficiency.

For example, the majority of our GHG emissions come from the energy we use across our facilities. Our focus is on making our facilities more efficient and generating electricity from lower-emission sources. During 2019, our top ten largest sites accounted for 76% of our total energy consumption. By these sites setting energy reduction targets, they have the biggest influence in reducing our energy use and, in turn, our direct and indirect GHG emissions.

All of these sites operate an environmental management system, with 100% certified to ISO[1] 14001, with an aim to reduce their energy consumption and in turn GHG emissions.

As a business, our aim is to continually improve energy efficiency and the de-carbonising of our energy supply to reduce GHG emissions. In the 12 months to 31 October 2019, Group-wide GHG emissions have seen a steady decline in most of the higher polluting sources, especially coal, resulting in both Scope 1 and 2 emissions falling. There has also been a 2.3% reduction in the number of kilometres travelled, which along with the increased fuel efficiency of aircraft, has led to a considerable reduction of 8.77% in Scope 3 emissions.

Throughout the organisation, we set objectives to improve the performance of our operations and reduce the generation of waste, emissions and other discharges, such as effluents.

Our businesses also set targets to reduce water consumption. Some common steps taken include turning off water-intensive machinery outside of working hours, preventing leaks from underground pipes and installing dual-flush lavatory cisterns.

To realise the most efficient reduction of emissions, waste and discharges we assess the full lifecycle of our products taking account of scarcity of resources and increasing environmental constraints, from design, manufacturing and use, to the end-of-life phase of our products, such as reconditioning and reuse.

1. International Organization for Standardization.

Greenhouse gas emissions data from 1 November 2018 to 31 October 2019 (tonnes CO_2e)

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

2019	480,932
2018	492,673[2]

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

2019	484,504
2018	514,187

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

2019	138,020
2018	151,280

Total greenhouse gas emissions[1]

2019	1,103,456
2018	1,158,140[2]

Total greenhouse gas emissions per employee[3]

2019	14
2018	14

1. Reviewed and confirmed by Ramboll UK Limited.
2. Initial Scope 1 and total amount of tCO_2e emitted in 2018 is lower than previously reported. This is due to an over-estimation of the amount of natural gas consumed within the UK during the previous reporting period.
3. Excluding share of equity accounted investments.

Methodology

The greenhouse gas emissions data is reported in line with the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard 'Operational Control' method, and emission factors for fuels and electricity are published at www.gov.uk/government/collections/government-conversion-factors-for-company-reporting.

For the 2019 reporting cycle, the 2019 emissions factors have been utilised as opposed to the 2018 factors. In previous years the emissions factors used for the Group's greenhouse gas emissions reporting have been a year behind, mainly due to the factors not being released in time for half-year assurance (for example, 2016 emissions factors used for 2017 reporting cycle). Going forward, the emissions factors used will coincide with the year of the reporting cycle as these are the latest factors available for the majority of the Group's reporting period.

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 517,035 tonnes CO_2e[1]. 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 GHG Protocol Guidance, this figure has been calculated using residual-mix emission factors where available for our UK, US and Swedish operations. In our other significant operating regions, residual-mix emission factors are either unavailable or the resulting absolute emissions at Group level are within the margin of error and, therefore, country-specific emissions factors have been used in line with the GHG Protocol Guidance.

To see our Basis of Reporting 2019 visit baesystems.com/2019crdata

Task Force on Climate-related Financial Disclosures (TCFD)

The TCFD was set up to develop recommendations to help companies and other organisations disclose clear, comparable and consistent information about the risks and opportunities presented by climate change.

We are supportive of the move to improve the coherence and consistency of disclosures in this area. We are working towards reporting our commitments on climate-related matters in line with the TCFD recommendations by 2022.

2020 priorities

During 2020 we will further evaluate the implications of climate-related risks and opportunities and further develop our approach to reporting on climate change in line with TCFD and establish targets for carbon across the Group.

Fostering strong community partnerships

Supporting causes that have meaning to our business and the communities in which we operate is important to us.

During 2019 the Group contributed more than £11m[1] to local, national and international charities and not-for-profit organisations through our community investment programme. This includes charitable sponsorships, donations, employee fundraising and volunteering.

Our approach

Our approach, aligned to our Community Investment Policy, aims to build and nurture mutually beneficial relationships between our business, our people and local stakeholders. We partner with organisations on initiatives that have meaning and impact to our business and employees.

We have key criteria, where measurable impact can be demonstrated, and these are:

- **Armed forces** – supporting active service personnel, veterans and their families;
- **Education and skills** – inspiring young people to consider STEM subjects and careers; and
- **Local community** – working to support the communities in which we operate.

Our community investment programme is governed by an overarching global strategy, and supported by market-level programmes. This approach allows markets to ensure their programme is relevant to their lines of business, charitable needs, culture and local communities, whilst being aligned to the overall Group approach.

Our policy does not allow payments to third party fundraisers nor directly to individuals, and is focused on ensuring the charitable organisation receives funding directly.

To avoid the risk of conflicts of interest, any community investment activity is tested against the principle that it does not place, or does not appear to place, actual or potential customers, suppliers or government officials under any obligations.

We have a Global Community Investment Committee which governs our approach, and there is a robust process (through our Operational Framework) in place to approve requests for community investment spend. This Committee reports to the Executive Committee on all community investment activities, including employee fundraising activities.

Our impact

We collaborate with organisations that can demonstrate a positive impact and encourage our employees to volunteer in support of their work. These include not-for-profit organisations and education providers.

We use the London Benchmarking Group methodology to define the value of our support and its impact on our community partners, in comparison with our peers and other organisations. Our reporting data is externally assured every year. All community investment-related expenditure and any associated employee fundraising is reported through an online system and validated by an external assurance provider.

As well as donations, sponsorship and employee fundraising, we develop and support structured education programmes and enable our employees to volunteer their skills and time. Volunteering remains an important part of our employees' career journey and can be pursued as a personal development goal. We actively seek partnerships where our employees can get involved and show their support. In Saudi Arabia and the UK our education ambassadors have offered their time to encourage school-age children to pursue STEM subjects and careers.

We have strong ties with armed forces charities across a number of our markets, and an important strand of our strategy is support for organisations that assist active service personnel, veterans and their families. In the UK we are supporting Team Invictus UK on their journey to the Invictus Games The Hague 2020, a partnership which has enabled a number of employees to get directly involved through volunteering. In the US we partner with The Mission Continues, which empowers veterans to continue their service in transformative ways within their communities and supports their transition to new careers that draw upon their military service.

Based on local practices, we apply matched funding and offer volunteering opportunities for our employees, encouraging them to support our charitable partners and communities in alignment with our Global Community Investment Strategy and focus areas.

Our communications team also supports awareness-raising efforts, promoting projects and community causes.

2020 priorities

During 2020, we will continue to focus on supporting the armed forces through established and new partnerships, and we will drive engagement with young people through our education programmes.

Investment in technology and research and development (R&D)

Technology and innovation underpin our strategy and the development of our products and services across Air, Maritime, Land and Cyber. By working across these domains, we can ensure that improvements in one area can be repurposed for others. For example, our patented waveguide technology – developed initially for the LiteHUD® head-up display to provide information to pilots – has now been miniaturised to fit in Augmented Reality glasses and trialled with the Royal Navy on a ship's bridge. We are also developing applications for use in civil aviation, which have the potential to provide significant improvements to operational performance and safety.

Our structured approach defines the capabilities and technologies we need to deliver our business and product strategy, which ensures a clear focus for our research and development spend. At the outset, we plan for multiple uses of our technology, maximising its value both financially and in capability delivered to our customers.

In 2019, we spent £1.5bn (2018 £1.5bn) on R&D, of which £237m (2018 £222m) was funded by BAE Systems. In addition, the Group's share of the R&D expenditure of its equity accounted investments in 2019 was £0.3bn (2018 £0.2bn).

We protect our investments in technologies and have a portfolio of patents and patent applications covering approximately 2,500 inventions worldwide. Combined with a clear strategy for managing our Intellectual Property, we seek to create additional value through licences and sales of rights to other organisations.

Collaboration

We partner with our customers, other companies and academia to develop new technologies, as well as investing in technologies or assets that complement our existing capabilities or our future product strategy. We often work with small- and medium-sized enterprises to develop embryonic technology that is then matured for use in our own products and services.

In the UK we work directly with our five Strategic University Partners on new technologies and currently sponsor over 90 PhD students under the Industrial Collaborative Awards in Science and Engineering programme, which allows postgraduate research students to receive high-quality research training in collaboration with a commercial partner. One example is the University of Southampton's research – in partnership with the University of Nottingham and Lloyd's Register – into new materials that make less noise underwater, intended to reduce the impact of shipping on marine life.

1. Deloitte LLP has provided limited assurance on the following community indicator – total value of Community Investment programme donations.

In our Electronic Systems sector in the US, we innovate science, technology and engineering breakthroughs to solve challenges spanning the areas of advanced electronics, autonomy, cyber, electronic warfare and sensors and processing for applications on programmes across the defence, aerospace and security domains. In particular, our FAST Labs™ R&D teams leverage internal resources and funding from US Department of Defense research organisations to accelerate the velocity of our innovation – moving faster and with a stronger sense of direction to more effectively address our customers' requirements for the rapid development of new technologies.

We also deploy seedcorn funding to develop technology or ideas that could deliver real value, but are too new or untested to offer guaranteed results. Over the last five years we have funded more than 40 projects with more than £40m of investment. Around half the projects have moved into product lines – in line with expectations for early-stage research and development programmes – and the potential business returns run into many times that value. One such project was our autonomous P24 Rigid Inflatable Sea Boat, now generating interest from customers around the world. Announced in July 2019, this is the first boat of its kind, capable of 100 nautical miles in autonomous pursuit mode.

Technology in our business

The use of technology, innovations and advanced manufacturing techniques across our business is essential in driving greater efficiency and increased productivity. Our Chief Technology Officer's team is dedicated to advancing and applying new technology throughout our business.

2020 priorities

In 2020 we will continue to increase collaboration both across the Group and with our strategic partners. The Tempest programme will continue to be a priority. These include significant efficiency improvements through our Industry 4.0 work, meaning high fidelity digital designs move more seamlessly through testing, manufacture, training and further development.

We are also developing several technologies to help customers improve sustainability, deliver greater operational efficiencies and reduce energy usage.

Governance

Our Chief Executive has primary responsibility for delivery of the business strategy. He is supported on sustainability matters by the Group Director Governance, Conduct and Sustainability who advises on sustainability strategy, its measurement and direction.

The governance of our business is fundamental to BAE Systems. Our Operational Framework sets out our approach and the policies, processes and standards to which we adhere, more detail of which is set out on pages 84 and 85.

Our Board Corporate Responsibility Committee is dedicated to the oversight of many aspects of the Company's performance in sustainability and it takes a longer-term view in reviewing challenges and opportunities in this area. The Committee meets as part of the Board's annual schedule of meetings (see page 88), and agrees the Group's priorities and objectives relating to our health and safety, ethics and responsible business conduct, responsible trading principles, diversity and inclusion, stakeholder and employee engagement (including the requirements of the UK Corporate Governance Code to understand the views of employees), and supplier conduct. As well as receiving regular updates on these areas, the Committee undertakes deep-dive activities into specific areas – such as when there has been a specific health and safety incident, or to further understand the specific challenges and successes of developing a diverse and inclusive workforce.

Of specific interest to the Committee is the adherence to responsible business policies around the Group. Due to differences in regulatory regimes and different commercial arrangements, implementation of these policies in some markets can be more challenging than in others. The Committee is therefore interested in understanding how BAE Systems practically does business in different markets, how responsible trading risks are managed and the decision-making process behind our presence in certain markets. The Committee looks for robust adherence to policies and also how any additional controls and compliance measures may be used to reduce both operational and reputational risk.

At Board level, the Corporate Responsibility Committee, along with the Audit Committee, reviews the Operational Assurance Statement completed by the businesses bi-annually.

For further information see our website baesystems.com/sustainability

84 Board governance

Group financial review

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.



Peter Lynas
Group Finance Director

Accounting change

With effect from 1 January 2019, the Group adopted IFRS 16 Leases. This results in almost all leases being recognised on the balance sheet by lessees. The Group has applied the modified retrospective transition approach and therefore has not restated comparative amounts for the year ended 31 December 2018.

Underlying EBITA and operating profit are both approximately £50m higher than the prior year as a depreciation charge on leased assets is reported, rather than the operating lease expense previously recognised. Net finance costs have also increased under IFRS 16 by approximately £50m owing to the recognition of the interest charge element of the lease liabilities.

Financial performance

Measures as defined by the Group

Sales
KPI

£20,109m

(2018 £18,407m)

Underlying EBITA[3]
KPI

£2,117m

(2018 £1,928m)

Underlying earnings per share[3,4]
BONUS KPI

Excluding one-off tax benefit

45.8p

(2018 42.9p)

Including one-off tax benefit

50.8p

(2018 42.9p)

Operating business cash flow[3]
KPI

£1,307m

(2018 £993m)

Net debt
BONUS KPI

£(743)m

(2018 £(904)m)

Order intake[5]
BONUS KPI

£18,447m

(2018 £28,280m)

Order backlog[5]

£45.4bn

(2018 £48.4bn)

Measures defined in IFRS[1]

Revenue

£18,305m

(2018 £16,821m)

Operating profit[3]

£1,899m

(2018 £1,605m)

Basic earnings per share[3]

46.4p

(2018 31.3p)

Net cash flow from operating activities[3]

£1,597m

(2018 £1,200m)

BONUS 75% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 122).

06 Alternative performance measure definitions

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. The financial impact of the adoption of IFRS 16 Leases is described on pages 44 to 51.
4. The one-off tax benefit is described on page 46.
5. Including share of equity accounted investments.

Income statement

Sales increased by £1.7bn to £20.1bn (2018 £18.4bn), a 7% increase on a constant currency basis[1].

Underlying EBITA increased to £2,117m (2018 £1,928m), giving a return on sales of 10.5% (2018 10.5%). Excluding the impacts of IFRS 16 and exchange translation, growth was 5%.

Revenue increased by £1.5bn to £18.3bn (2018 £16.8bn), a 7% increase on a constant currency basis[1].

Operating profit increased by £294m to £1,899m (2018 £1,605m). There was a favourable exchange translation impact of £36m.

Non-recurring items in 2019 of £27m comprises a £36m charge relating to the derecognition of Enterprise Resource Planning software intangible assets in the Air sector, charges of £13m relating to legal disputes arising from historical disposals, a gain of £14m on the sale of the Group's 55% shareholding in BAE Systems Global Combat Systems Limited upon formation of the Rheinmetall BAE Systems Land joint venture, and a gain of £8m relating to the disposal of Aircraft Accessories and Components Company. Non-recurring items in 2018 of £154m represented a Guaranteed Minimum Pension equalisation charge of £114m, and a loss on disposal of the Mobile, Alabama, shipyard of £40m.

Amortisation of intangible assets is £109m (2018 £85m), the increase mainly a result of new IT systems becoming operational.

Impairment of intangible assets in 2019 is £6m. In 2018 the charge represented the impairment of Silversky customer-related intangibles in the Applied Intelligence business.

Net finance costs, including equity accounted investments, were £296m (2018 £394m). The underlying interest charge, excluding pension accounting, and fair value and foreign exchange adjustments on financial instruments and investments increased to £257m (2018 £215m). Net interest expense on the Group's pension deficit was £117m (2018 £106m). There was a credit in respect of fair value and foreign exchange adjustments of £78m (2018 £73m charge) on exchange translation of US dollar-denominated bonds.

Taxation expense, including equity accounted investments, of £147m (2018 £229m) reflects the Group's underlying effective tax rate for the year of 19%, less a £161m credit in respect of two items. Following agreements reached in respect of overseas tax matters, a one-off benefit has been recognised; and following review of the April 2019 EU Commission decision that concluded that the UK's Controlled Foreign Company regime partially represents State Aid, a provision has been recognised for the estimated exposure. The underlying effective rate increased to 19% from 18% in 2018.

The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 174.

The underlying effective tax rate for 2020 is expected to increase from 19% to around 20%, with the final rate dependent on the geographical mix of profits.

Income statement

Financial performance measures as defined by the Group		2019 £m	2018 £m
Sales	KPI	**20,109**	18,407
Underlying EBITA	KPI	**2,117**	1,928
Return on sales		**10.5%**	10.5%

Financial performance measures defined in IFRS[2]	£m	£m
Revenue	**18,305**	16,821
Operating profit	**1,899**	1,605
Return on revenue	**10.4%**	9.5%

Reconciliation of sales to revenue		£m	£m
Sales	KPI	**20,109**	18,407
Deduct Share of sales by equity accounted investments		**(2,878)**	(2,812)
Add Sales to equity accounted investments		**1,074**	1,226
Revenue		**18,305**	16,821

Reconciliation of underlying EBITA to operating profit		£m	£m
Underlying EBITA	KPI	**2,117**	1,928
Non-recurring items		**(27)**	(154)
Amortisation of intangible assets		**(109)**	(85)
Impairment of intangible assets		**(6)**	(33)
Financial expense of equity accounted investments		**(23)**	(13)
Taxation expense of equity accounted investments		**(53)**	(38)
Operating profit		**1,899**	1,605
Net finance costs		**(273)**	(381)
Taxation expense		**(94)**	(191)
Profit for the year		**1,532**	1,033
Underlying interest expense[3]		**(257)**	(215)
Net interest expense on post-employment benefit obligations		**(117)**	(106)
Fair value and foreign exchange adjustments on financial instruments and investments		**78**	(73)
Net finance costs (including equity accounted investments)		**(296)**	(394)

Exchange rates

Average	2019	2018
£/$	**1.277**	1.335
£/€	**1.141**	1.130
£/A$	**1.836**	1.786

Sensitivity analysis	
Estimated impact on sales of a ten cent movement in the average exchange rate	£m
$	**675**
€	**100**
A$	**40**

Earnings per share

Underlying earnings per share excluding the one-off tax benefit for the year increased by 7% to 45.8p (2018 42.9p). Underlying earnings per share including the one-off tax benefit for the year was 50.8p.

Basic earnings per share was 46.4p (2018 31.3p).

The application of IFRS 16 Leases for the first time in 2019 has had no material impact on earnings per share.

Orders

Order intake[4] decreased by £9.8bn to £18,447m (2018 £28,280m).

Order backlog[4] decreased by £3.0bn to £45.4bn, with trading on multi-year, long-term contracts in the Air sector partly offset by growth in the US businesses.

Earnings per share			
Financial performance measures as defined by the Group		**2019**	2018
Underlying earnings (excluding the one-off tax benefit)		**£1,457m**	£1,370m
Underlying earnings per share (excluding the one-off tax benefit)	KPI	**45.8p**	42.9p
Underlying earnings (including the one-off tax benefit)		**£1,618m**	£1,370m
Underlying earnings per share (including the one-off tax benefit)		**50.8p**	42.9p
Financial performance measures defined in IFRS[2]			
Profit for the year attributable to equity shareholders		**£1,476m**	£1,000m
Basic earnings per share		**46.4p**	31.3p
Reconciliation of underlying EBITA to underlying earnings		**£m**	£m
Underlying EBITA		**2,117**	1,928
Underlying net interest expense (including equity accounted investments)[3]		**(257)**	(215)
		1,860	1,713
Taxation expense (at the underlying effective tax rate, excluding the one-off tax benefit)		**(347)**	(310)
Non-controlling interests		**(56)**	(33)
Underlying earnings (excluding the one-off tax benefit)		**1,457**	1,370
One-off tax benefit		**161**	–
Underlying earnings (including the one-off tax benefit)		**1,618**	1,370
Reconciliation of underlying earnings to profit for the year attributable to equity shareholders		**£m**	£m
Underlying earnings (excluding the one-off tax benefit)		**1,457**	1,370
Non-recurring items, post tax		**(18)**	(126)
Amortisation and impairment of intangible assets, post tax		**(93)**	(97)
Net interest expense on post-employment benefit obligations, post tax		**(95)**	(87)
Fair value and foreign exchange adjustments on financial instruments and investments, post tax		**64**	(60)
One-off tax benefit		**161**	–
Profit for the year attributable to equity shareholders		**1,476**	1,000
Non-controlling interests		**56**	33
Profit for the year		**1,532**	1,033

Orders			
Financial performance measures as defined by the Group		**2019**	2018
Order intake[4]	KPI	**£18,447m**	£28,280m
Order backlog[4]		**£45.4bn**	£48.4bn

1. Current year compared with prior year translated at current year exchange rates.
2. International Financial Reporting Standards.
3. Underlying net interest expense is defined as finance costs for the Group and its share of equity accounted investments, excluding net interest expense on post-employment benefit obligations and fair value and foreign exchange adjustments on financial instruments and investments.
4. Including share of equity accounted investments.

Cash flow			
Financial performance measures as defined by the Group		2019 £m	2018 £m
Operating business cash flow	KPI	1,307	993
Financial performance measures defined in IFRS[1]		£m	£m
Net cash flow from operating activities		1,597	1,200
Reconciliation from operating business cash flow to net cash flow from operating activities		£m	£m
Operating business cash flow	KPI	1,307	993
Add back Net capital expenditure and financial investment		454	464
Add back Principal element of lease payments and receipts		230	–
Deduct Dividends received from equity accounted investments		(142)	(57)
Deduct Taxation		(252)	(200)
Net cash flow from operating activities		1,597	1,200
Net capital expenditure and financial investment		(454)	(464)
Principal element of finance lease receipts		9	–
Dividends received from equity accounted investments		142	57
Interest received		28	25
Acquisitions and disposals[1]		43	24
Net cash flow from investing activities		(232)	(358)
Interest paid		(233)	(203)
Net sale of own shares		–	1
Equity dividends paid		(724)	(703)
Partial disposal of shareholding in subsidiary undertaking[1]		31	17
Dividends paid to non-controlling interests		(56)	(28)
Principal element of lease payments		(239)	–
Cash flow from matured derivative financial instruments (excluding cash flow hedges)		40	6
Movement in cash collateral		1	2
Net cash flow from loans		(782)	(7)
Net cash flow from financing activities		(1,962)	(915)
Net decrease in cash and cash equivalents		(597)	(73)
Add back Net cash flow from loans		782	7
Foreign exchange translation		72	(188)
Other non-cash movements		(96)	102
Decrease/(increase) in net debt		161	(152)
Opening net debt		(904)	(752)
Net debt	KPI	(743)	(904)
Operating business cash flow		1,307	993
Interest paid, net of interest received		(205)	(178)
Taxation		(252)	(200)
Free cash flow (as defined by the Group)[2]		850	615

1. 2018 comparatives have been reclassified to present a cash inflow of £17m in respect of a partial disposal of the Group's shareholding in a subsidiary undertaking within financing activities. This cash flow was previously presented in investing activities.

214 Notes 26 and 28 to the Group accounts

Cash flow

Operating business cash inflow was £1,307m (2018 £993m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £231m on a funding basis.

Net cash inflow from operating activities was £1,597m (2018 £1,200m). Under IFRS 16 net lease cash outflows of £273m are now classified under financing and investing activities.

Taxation payments increased to £252m (2018 £200m) partly reflecting payments in Australia following the end of utilisation of prior year losses.

Net capital expenditure and financial investment was £454m (2018 £464m).

Dividends received from equity accounted investments of £142m (2018 £57m) were primarily receipts from MBDA (£73m), Advanced Electronics Company (£38m) and FNSS (£17m).

Interest received was £28m (2018 £25m).

The cash inflows in respect of **acquisitions, disposals, held for sale assets** and the **partial disposal of shareholdings in subsidiary undertakings** represent the disposal of Aircraft Accessories and Components Company (£26m), the disposal of the UK-based land vehicles business into the RBSL joint venture (£29m), the reduction in the Group's shareholding in Overhaul and Maintenance Company (£31m) (2018 £17m), less the investment in Riptide Autonomous Solutions (£9m) and the Prismatic acquisition (£3m). The cash inflow in 2018 of £24m included cash acquired as part of the ASC Shipbuilding acquisition (£14m) and cash received on the sale of the Mobile, Alabama, shipyard (£12m).

Interest paid was £233m (2018 £203m).

Equity dividends paid in 2019 represents the 2018 final (£423m) and 2019 interim (£301m) dividends.

Dividends paid to non-controlling interests increased to £56m (2018 £28m), reflecting a higher payment by Saudi Maintenance & Supply Chain Management Company, in which the Group has a 51% shareholding.

There was a **cash inflow from matured derivative financial instruments** of £40m (2018 £6m), arising from rolling hedges relating to balances within the Group's subsidiaries and equity accounted investments.

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

1. International Financial Reporting Standards.
2. Free cash flow is defined as operating business cash flow less interest paid (net) and taxation.

Balance sheet

Summarised balance sheet		2019 £m	2018 £m
Intangible assets		**10,371**	10,658
Property, plant and equipment, right-of-use assets and investment property[1]		**3,188**	2,017
Equity accounted investments and other investments		**441**	442
Working capital[1,2]		**(2,854)**	(3,191)
Lease liabilities		**(1,291)**	–
Group's share of net IAS 19 post-employment benefits deficit[2]		**(4,455)**	(4,029)
Net tax assets and liabilities		**690**	449
Net other financial assets and liabilities		**34**	70
Net debt	KPI	**(743)**	(904)
Net assets held for sale		**130**	106
Net assets		**5,511**	5,618

1. Funding received of £524m (2018 £446m) 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.
2. The Saudi Arabia end of service benefit obligation of £97m at 31 December 2018 has been reclassified from trade and other payables to post-retirement benefit obligations.

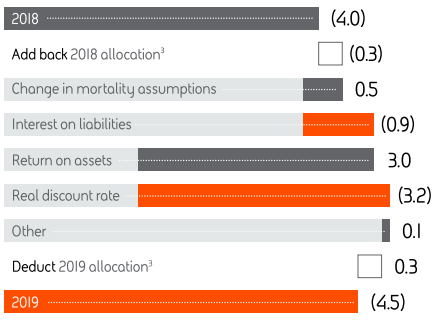
Components of net debt		£m	£m
Cash and cash equivalents		**2,587**	3,232
Debt-related derivative financial instruments (net)		**67**	163
Loans – non-current		**(3,020)**	(3,514)
Loans and overdrafts – current		**(377)**	(785)
Net debt	KPI	**(743)**	(904)

Exchange rates

Year end	2019	2018
£/$	**1.324**	1.274
£/€	**1.180**	1.114
£/A$	**1.884**	1.809

Accounting net pension deficit – bridge

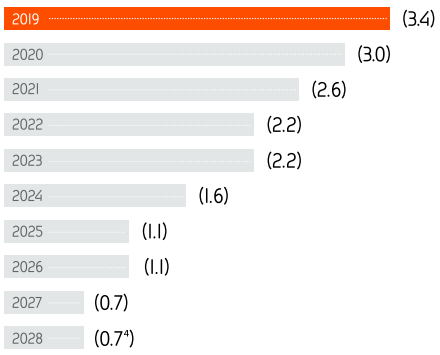
(£bn)



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Maturity of the Group's borrowings

(£bn)



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3. Amounts allocated to equity accounted investments.
4. Repayable in 2041 (£0.3bn) and 2044 (£0.4bn).

Balance sheet

The £0.3bn decrease in **intangible assets** to £10.4bn (2018 £10.7bn) mainly reflects exchange translation.

Property, plant and equipment, right-of-use assets and investment property is £3.2bn (2018 £2.0bn). Under IFRS 16 Leases, the balance sheet now includes **right-of-use assets** and **lease liabilities**.

Equity accounted investments and other investments was broadly unchanged at £441m (2018 £442m) mainly reflecting the Group's share of profit for the year (£168m), offset by increased pension allocation from the higher deficit (£52m) and dividends received (£142m). The new investment in the RBSL joint venture more than offsets the reclassification to held for sale of Advanced Electronics Company.

The **Group's share of the net IAS 19 post-employment benefits deficit** increased to £4.5bn (2018 £4.0bn). The impact of lower discount rates increasing liabilities was partly offset by strong asset returns and changes in mortality assumptions. The major movements in the net deficit are shown in the bridge chart on this page.

Details of the Group's post-employment benefits schemes are provided in note 23 to the Group accounts on page 200.

A net deferred tax asset of £0.8bn (2018 £0.7bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

In aggregate, there was a £0.3bn increase in **working capital** largely reflecting utilisation of provisions, some inventory build in the US businesses and timing of receivables. There was some usage of last year's customer funding on the Qatar programme.

The Group's **net debt** at 31 December 2019 is £743m, a net decrease of £161m from the position at the start of the year. The $1bn 6.375% bond, of which $500m had been converted into a floating rate bond by utilising interest rate swaps, matured and was repaid in June 2019. The maturity of the Group's borrowings is shown in the chart on this page.

Cash and cash equivalents of £2,587m (2018 £3,232m) are held primarily for the repayment of debt securities, pension deficit funding, payment of the 2019 final dividend and management of working capital.

Net assets held for sale represent the Applied Intelligence US-based software-as-a-service business and Advanced Electronics Company in Saudi Arabia. The 2018 net assets held for sale comprised the UK-based combat vehicles business, where the Group subsequently formed a joint venture with Rheinmetall, and the Overhaul and Maintenance Company's 85.7% shareholding in Aircraft Accessories and Components Company, the disposal of which completed in January 2019.

Accounting policies

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 £18.3bn (year ended 31 December 2019)
See note 1 to the Group accounts

Carrying value of goodwill
Goodwill £10.0bn (at 31 December 2019)
See note 8 to the Group accounts

Deferred tax asset on post-employment benefit obligations
Deferred tax asset on post-employment scheme deficits £0.8bn (at 31 December 2019)
See note 15 to the Group accounts

Tax provisions
Tax provisions £180m (at 31 December 2019)
See note 17 to the Group accounts

Post-employment benefit obligations
Group's share of the net IAS 19 post-employment scheme deficit £4.5bn (at 31 December 2019)
See note 23 to the Group accounts

158 Critical accounting policies

Changes in accounting policies

With effect from 1 January 2019, the Group adopted IFRS 16 Leases. This results in almost all leases being recognised on the balance sheet by lessees. The Group has applied the modified retrospective transition approach and therefore has not restated comparative amounts for the year ended 31 December 2018.

There are no accounting policy changes which are expected to have a significant impact on the Group with effect from 1 January 2020.

Capital

Objectives

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

- meeting its pension obligations;
- investing in research and technology and pursuing other 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:

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

212 Note 25 to the Group accounts

Dividends

As part of the Group's capital allocation policy, 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 13.8p per share making a total of 23.2p per share for the year, an increase of 4.5% over 2018. At this level, the annual dividend is covered two times by underlying earnings. Subject to shareholder approval at the 2020 Annual General Meeting, the dividend will be paid on 1 June 2020 to holders of ordinary shares registered on 17 April 2020. The ex-dividend date is 16 April 2020.

At 31 December 2019, the Company had retained earnings of £3.0bn (2018 £2.8bn), the non-distributable portion of which is £767m (2018 £707m) (see page 226). Total external dividends relating to 2019 are £743m (2018 £711m), including the interim dividend paid during the year of £301m (2018 £288m) and the final dividend proposed of approximately £442m (2018 £423m). On an annual basis, the Company receives dividends from its subsidiaries to increase 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 pages 89 and 90).

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 April 2024 is available to meet 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 strong 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:
  (a) the income statements or balance sheets of foreign subsidiaries; and
  (b) equity accounted investments it regards as long-term investments.

189 Note 14 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 does not tolerate activities designed to facilitate tax evasion offences.

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 July 2018 (www.cbi.org.uk/media/3710/2018-02-07-statement-of-tax-principles.pdf).

173 Note 6 to the Group accounts

Guidance for 2020

Whilst the Group is subject to geopolitical uncertainties, the following guidance is provided on current expected operational performance.

Impacts from the proposed acquisitions announced in January of the Collins Aerospace Military Global Positioning System business and Raytheon's Airborne Tactical Radios business are not included in the following guidance.

For the year ending 31 December 2020, the Group's underlying earnings per share is expected to grow by mid-single digit percentage compared to the full-year underlying earnings per share in 2019 of 45.8p, assuming a $1.30 to sterling exchange rate.

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 2019 are provided in the Group financial review on pages 44 to 51.



Electronic Systems

- Sales, in US dollar terms, are expected to show mid-single digit percentage growth driven by a number of electronic warfare contracts including F-35. Some 70% of projected sales are in the 2019 closing order backlog, similar to last year.
- Margin[1] is expected to be at the higher end of our 14% to 16% range.



Cyber & Intelligence

- In aggregate, we expect sales to be in line with 2019.
- The US business, which represented some 70% of this segment in 2019, is expected to show low-single digit percentage growth.
- In the Applied Intelligence business we expect good top line expansion in the Government and Financial Services areas. However, the proposed disposal of the Silversky business is expected to reduce sales by approximately $100m.
- Margin[1] in 2020 is expected to improve into the 7% to 8% range. The US business is again expected to contribute around the 8% to 9% mark. In Applied Intelligence we expect the business to move back into profitability absent the restructuring charge and following the expected exit of the two proposed business disposals.



Platforms & Services (US)

- Sales, in US dollar terms, are expected to show high-single digit percentage growth with increasing volumes from the US Combat Vehicles backlog and in ship repair. More than 80% of guidance is within the closing order backlog, similar to last year.
- Margin[1] is expected to remain at the low end of the 8% to 9% range. The ramp up of vehicle deliveries, particularly on the Armored Multi-Purpose Vehicle, together with trading of the Mobile Protected Firepower development programme will continue to be at initial low margin levels.



Air

- Sales are expected to show mid-single digit percentage growth, for increased activity on the Qatar Typhoon and Hawk programme and on F-35 as full rate production levels are achieved. Close to 90% of sales guidance is within the closing order backlog.
- Margin[1] is expected to be lower than 2019, towards the bottom end of our 11% to 13% range. There is a headwind from higher pension service costs, as well as the further increase in self-funded research and development expenditure on the Tempest programme. Partly offsetting these is an expected step up in Qatar margin recognition.



Maritime

- Sales are expected to be stable overall. Activity on the Carrier and Offshore Patrol Vessel programmes is almost complete. These are offset by increases in the Dreadnought submarine and Type 26 programmes. Around 80% of guidance is already covered by the order backlog.
- Margin[1] levels are expected to be at the top end of our 8% to 9% range.

HQ

- HQ costs are expected to be slightly lower than in 2019.

- Underlying finance costs are expected to be around 10% lower. There will be a full year of benefit following the repayment of the high coupon $1bn bond in June 2019. Net present value charges will also be lower. These will be partly offset by the cost of the term debt to support the planned £1bn of accelerated pension deficit funding.
- The underlying effective tax rate is expected to increase from 19% to around 20%, with the final rate dependent on the geographical mix of profits.
- Minority interest is expected to increase to around £75m as we complete further sell downs in our Saudi partner companies.
- The Group is targeting free cash flow of £3.5bn to £3.8bn in the three-year period 2020 to 2022, with close to £1bn expected in 2020.

1. Underlying EBITA as a percentage of sales.

Segmental review

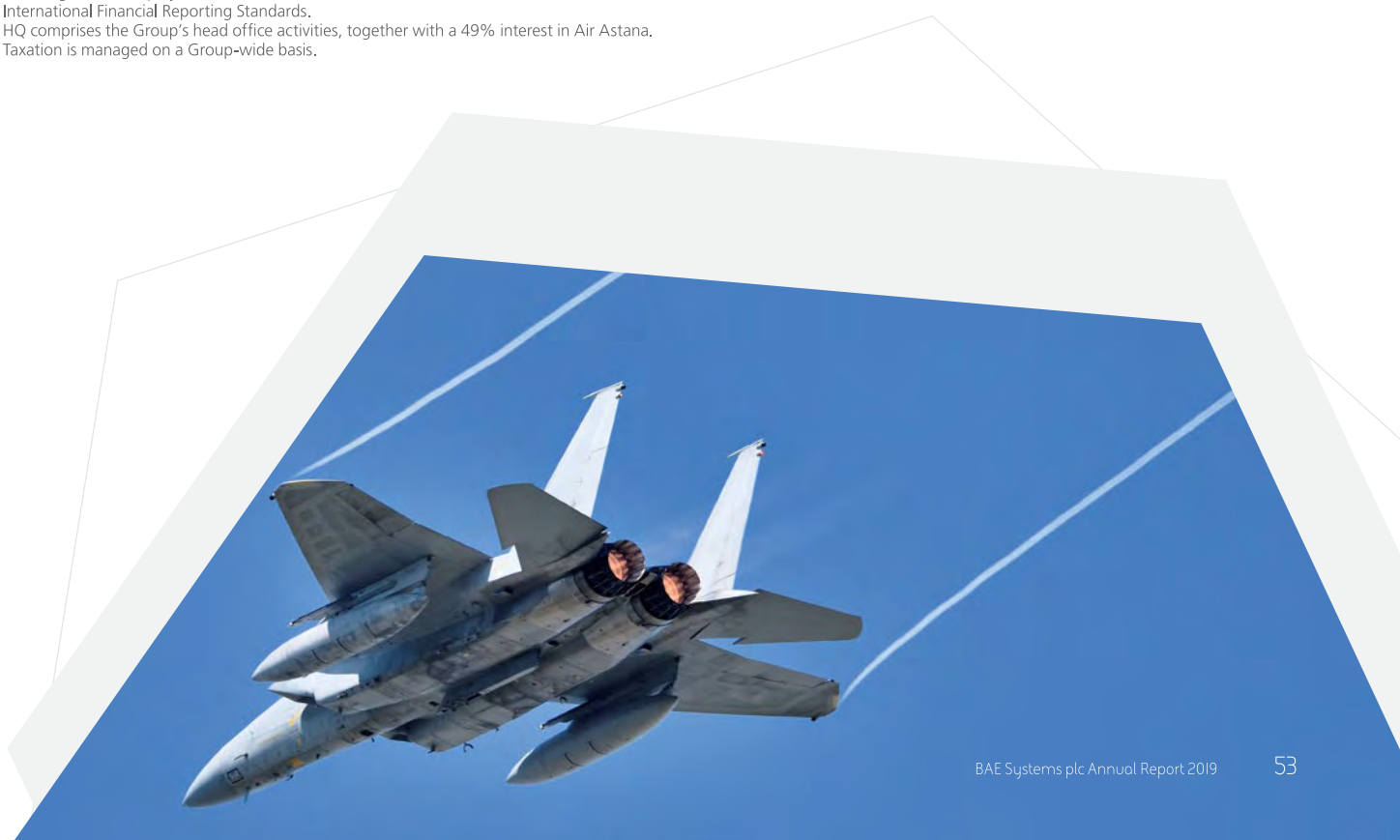
The Group reports its performance through five principal reporting segments.

Financial performance measures

Year ended 31 December 2019	As defined by the Group: Sales £m	Underlying EBITA £m	Return on sales %	Operating business cash flow £m	Order intake[1] £m	Order backlog[1] £bn	Defined in IFRS[2]: Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m
54 Electronic Systems	4,439	687	15.5	672	5,023	6.0	4,439	672	15.1	833
58 Cyber & Intelligence	1,732	91	5.3	68	1,846	1.8	1,732	80	4.6	99
62 Platforms & Services (US)	3,337	267	8.0	241	4,020	5.8	3,185	239	7.5	305
66 Air	7,457	887	11.9	408	4,594	23.9	6,153	777	12.6	497
70 Maritime	3,116	268	8.6	150	2,875	8.6	3,071	253	8.2	289
HQ[3]	387	(83)		(232)	386	–	43	(122)		(174)
Deduct Intra-group	(359)				(297)	(0.7)	(318)			
Deduct Taxation[4]										(252)
Total	**20,109**	**2,117**	**10.5**	**1,307**	**18,447**	**45.4**	**18,305**	**1,899**	**10.4**	**1,597**

We use financial performance measures as defined by the Group to monitor the underlying financial performance of the Group's reporting segments. Reconciliations from these measures to the financial performance measures defined in IFRS[2] are provided in the Group financial review on pages 44 to 51. Reconciliations by reporting segment for revenue and operating profit are included in note 1 to the Group accounts (see page 165) and for net cash flow from operating activities in note 26 to the Group accounts (see page 214).

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



Electronic Systems

Segmental review continued

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, precision guidance and seeker solutions, next-generation military communications systems and data links, persistent surveillance capabilities and hybrid-electric drive systems.

Electronic Combat Solutions provides a depth of capability in advanced electronic warfare solutions for airborne applications, including electronic support, electronic attack, and electronic protection technologies.

Survivability, Targeting & Sensing Solutions 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.

C4ISR Systems 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 resiliency products.

Controls & Avionics Solutions develops and produces electronics for military and commercial aircraft, including fly-by-wire flight controls, full authority digital engine controls, flight deck systems, cabin management systems and mission computers.

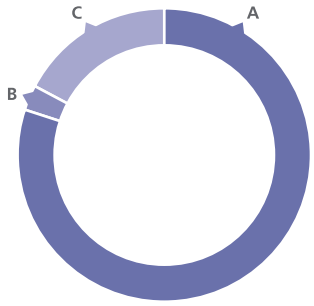
Power & Propulsion Solutions delivers electric propulsion and power management performance, with innovative products and solutions that advance vehicle mobility, efficiency and capability in the transit, military, marine and rail markets.

Technology
At the core of Electronic Systems, our FAST Labs™ innovation hub supports R&D across the business, developing and proving new technologies to accelerate their transition into customer programmes. Our FAST Labs scientists and engineers create and evolve technology capabilities in advanced electronics, autonomy, cyber, electronic warfare, and sensors and processing, often in partnership with the US Defense Advanced Research Projects Agency, universities, commercial technology companies and other research laboratories, to solve complex challenges in the fields of defence, aerospace and security.



Sales by domain

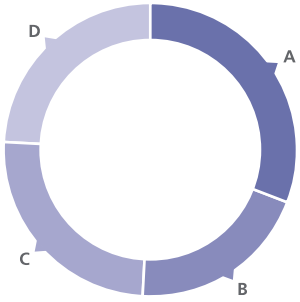
(%)



A	Air	80%
B	Maritime	3%
C	Land	17%

Sales by line of business

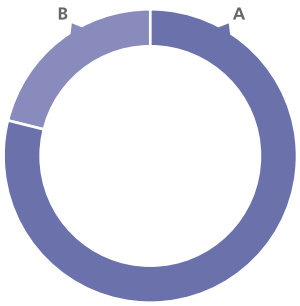
(%)



A	Electronic Combat	31%
B	Survivability, Targeting & Sensing	20%
C	C4ISR Systems	25%
D	Controls & Avionics/ Power & Propulsion Solutions	24%

Sales analysis: Defence and commercial

(%)



A	Defence	79%
B	Commercial	21%

Operational and strategic key points

- Growing demand for Advanced Precision Kill Weapon System (APKWS®) laser-guided rockets, with production awards totalling over $400m (£302m) received in the year.
- Over 500 electronic warfare systems delivered for the F-35 Lightning II programme, and awarded production and Block 4 modernisation contracts worth more than $750m (£566m).
- Acquired Riptide Autonomous Solutions to advance capabilities in maritime mission requirements.
- Continuing growth in space resilience domain.
- Establishing new facilities in Huntsville, Alabama and Manchester, New Hampshire to meet the record order backlog.
- Active interceptors certified for Gulfstream G500 and G600 jets and in production.
- Battery electric and fuel cell electric transit systems recorded five million zero emission miles.

Employees[1]

16,600

Financial performance

Financial performance measures as defined by the Group

		2019	2018
Sales	KPI	**£4,439m**	£3,965m
Underlying EBITA	KPI	**£687m**	£606m
Return on sales		**15.5%**	15.3%
Operating business cash flow	KPI	**£672m**	£431m
Order intake[1]	KPI	**£5,023m**	£4,624m
Order backlog[1]		**£6.0bn**	£5.4bn

Financial performance measures defined in IFRS[2]

	2019	2018
Revenue	**£4,439m**	£3,965m
Operating profit	**£672m**	£590m
Return on revenue	**15.1%**	14.9%
Cash flow from operating activities	**£833m**	£575m

- Sales compared to 2018 were up 7% at $5.7bn (£4.4bn). Growth in the defence business was at 9% driven by the F-35 programme, APKWS® volumes and increased classified activity. Commercial sales of engine and flight controls and hybrid-electric drive systems also grew and at $1.2bn (£0.9bn) now amount to 21% of the sector.
- Underlying EBITA was up to $877m (£687m), delivering a return on sales of 15.5%, at the higher end of our guidance range.
- As expected, cash conversion of EBITA[3] was very strong in the second half of the year, and close to 100% for the full year.
- Order backlog was another record high, at $7.9bn (£6.0bn), with significant awards on F-35 for LRIP 14 and Block 4 development, APKWS® volumes and the Radar Warning Receiver upgrade.

Sales

£4,439m

06 Alternative performance measure definitions

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.
3. Operating business cash flow as a percentage of underlying EBITA.

Electronic Systems

Segmental review continued

Operational performance

Electronic Combat Solutions

Staying at the forefront of emerging threats and delivering next-generation electronic warfare (EW) capabilities are important discriminators for success. As a leader in EW, we continue to see growth across our portfolio for both US and international customers.

The F-35 Lightning II programme completed deliveries for Lot 11 and achieved the milestone of delivering over 500 EW systems. In addition, the programme was awarded a Block 4 modernisation and further F-35 EW system production contracts from Lockheed Martin totalling over $750m (£566m). We continue to operate under a five-year Performance Based Logistics contract to provide material availability and support for the F-35 sustainment programme.

Executing on our current contract from Boeing, we continue to deliver to the United States Air Force our Eagle Passive Active Warning Survivability System, which provides advanced aircraft protection and has completed successful F-15 aircraft flight tests despite experiencing cost and schedule overruns. We were also awarded a $495m (£374m) contract to digitally upgrade our ALR-56 Radar Warning Receiver system, enhancing the capability of our technology on F-15 jets.

Providing advanced EW capability for international F-15 aircraft, we continue to deliver on our contract from Boeing and Warner Robins Air Logistics Complex, totalling more than $1bn (£0.8bn) for the installation of the Digital Electronic Warfare System (DEWS) on new and existing F-15 aircraft. We are also executing a contract worth in excess of $300m (£227m) to provide DEWS to support the sale of new F-15 aircraft to another international customer.

As a provider of the long-range sensor and targeting technology for the Long Range Anti-Ship Missile (LRASM), we have completed Lot 1 production for our prime contractor Lockheed Martin. In addition, we received a contract modification to a previous Lot 2 production award, increasing this contract award to $78m (£59m).

The Compass Call programme continues its long history of sustaining and upgrading the prime mission equipment in support of the existing EC-130H fleet. Cross-decking the mission system onto the newly-designated Gulfstream G550 jet, the programme is currently executing contracts with a total value of nearly $500m (£378m).

Due to the sensitive nature of electronic combat systems and technology, approximately one quarter of our revenues in this business area are driven by our work on classified programmes.

Survivability, Targeting & Sensing Solutions

Our APKWS® laser-guided rocket is experiencing growing demand, with over 36,000 units delivered to date. The programme received a five-year Indefinite Delivery, Indefinite Quantity contract worth up to $2.7bn (£2.0bn). Further production awards totalling over $400m (£302m) were received this year. In addition to expanding US military use, the system is generating strong international interest.

We are developing a next-generation missile warning system for the US Army under the Limited Interim Missile Warning System programme. We are completing qualification and continue to support government testing. We also received additional funding to enable fielding on other US Army aircraft variants.

Both fixed- and rotary-wing demonstrations of our Striker® II helmet-mounted display are ongoing and full development awaits customer funding.

C4ISR Systems

Consistent with our strategy to obtain and incubate small business innovations that can yield disruptive technology breakthroughs, our Electronic Systems FAST Labs™ organisation acquired the key assets of Riptide Autonomous Solutions to advance our capabilities to address expanding maritime mission requirements for integrated, flexible, modular, unmanned underwater vehicle solutions.

In the space resilience domain, we are a leading provider of space-qualified subsystems and components. We continue to experience growth in the areas of integrated on-board processors, reconfigurable processing payloads and secure communications. In May, our radiation-hardened electronic products achieved 10,000 cumulative years in orbit.

We have been awarded funding from the Defense Advanced Research Projects Agency to integrate machine-learning into platforms that exploit radio frequency signals in increasingly crowded electromagnetic spectrum environments. Our flexible, reconfigurable hardware solutions will provide commercial and military users with greater, automated situational awareness of their operating environment.



Controls & Avionics Solutions

We continue to develop the integrated flight control electronics and remote electronic units for Boeing's next-generation 777X aircraft. A successful first flight of the aircraft was conducted in January 2020 and the business is continuing software updates and systems verification testing in support of the aircraft certification efforts. During the year, our 737 MAX production rates were scaled back in line with Boeing's reduced demand.

Our active inceptors received certification for the Gulfstream G500 and G600 and are now in production. A derivative, LinkEdge™ (Active Parallel Actuation Subsystem), is being developed for the Chinook CH-47.

Our engine control product line continues to see strong performance from FADEC Alliance, a joint venture between GE Aviation and FADEC International (our joint venture with Safran Electronics & Defense). We have successfully completed component certification testing of the engine control for the Boeing 777X aircraft.

Under the recently-awarded Improved Turbine Engine Program, we will provide the Electronic Engine Controls to modernise the US Army's Black Hawk and Apache fleets.

Development of the F-35 vehicle management computer technology refresh is proceeding to plan and we are actively engaged with Lockheed Martin Aeronautics in moving towards a sustainment contract for the active inceptor systems.

Power & Propulsion Solutions

With 12,000 electric-hybrid propulsion transit buses in operation globally, we have launched the next-generation battery electric system to a market moving to zero emission technology. This year, our battery electric and fuel cell electric systems recorded five million zero emission miles. As cities work to reach low emission targets, this number is expected to grow significantly.

The demand for low and zero emission technology is growing in both commercial and military applications, with a number of European cities employing fully electric vehicles powered by our technology. Our first and largest transit customer, New York City Transit (Metropolitan Transportation Authority) announced its decision to purchase up to a further 435 electric-hybrid power and propulsion systems from BAE Systems. In addition, the maritime domain is now adopting green technology and our electric-hybrid systems are powering both passenger and cargo vessels.

Looking forward

Forward-looking information for the Electronic Systems reporting segment is provided later in this report.

74 Segmental looking forward

Our strategy in action

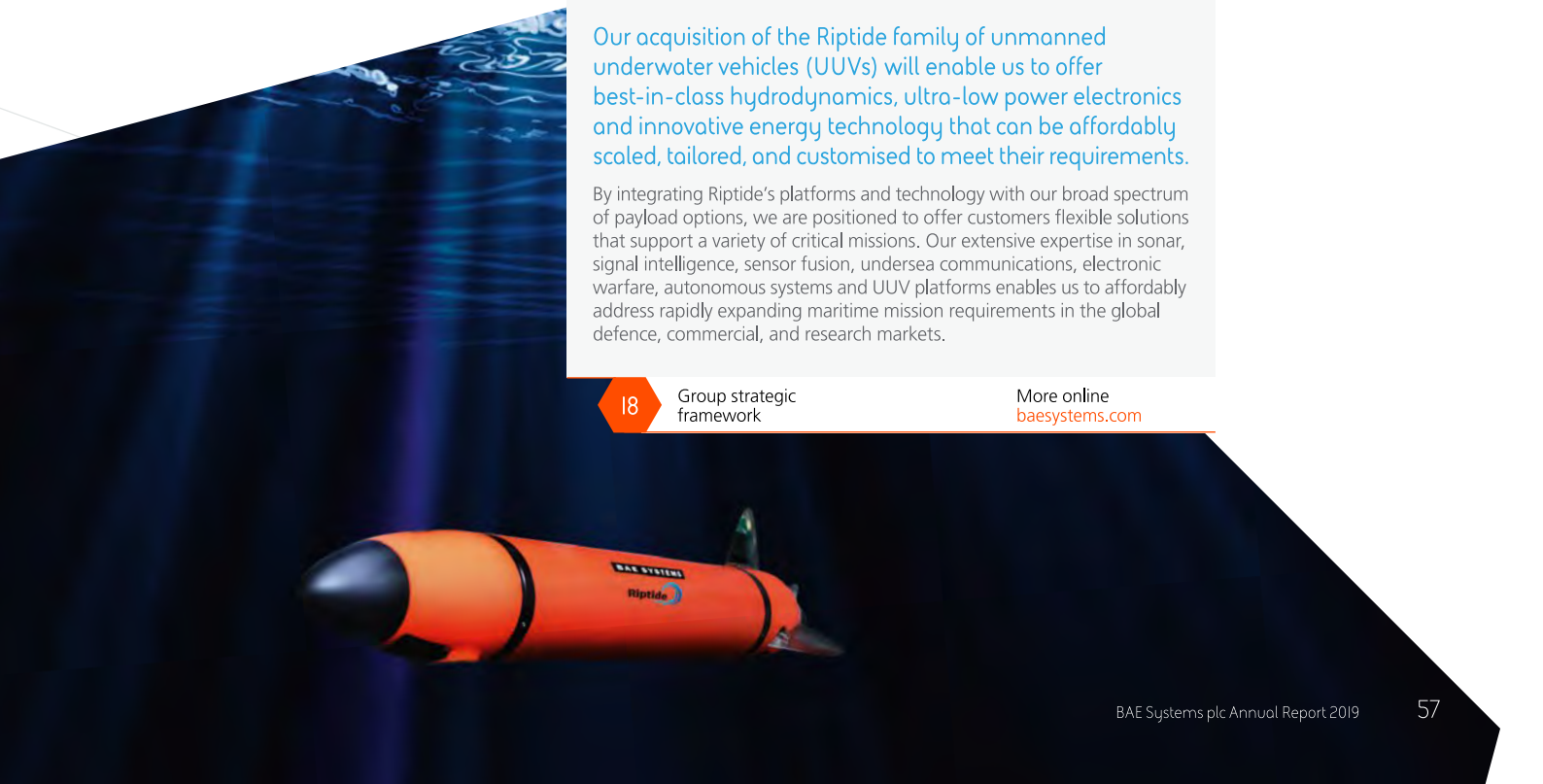
Integrating our technology to address underwater missions

Our acquisition of the Riptide family of unmanned underwater vehicles (UUVs) will enable us to offer best-in-class hydrodynamics, ultra-low power electronics and innovative energy technology that can be affordably scaled, tailored, and customised to meet their requirements.

By integrating Riptide's platforms and technology with our broad spectrum of payload options, we are positioned to offer customers flexible solutions that support a variety of critical missions. Our extensive expertise in sonar, signal intelligence, sensor fusion, undersea communications, electronic warfare, autonomous systems and UUV platforms enables us to affordably address rapidly expanding maritime mission requirements in the global defence, commercial, and research markets.

18 Group strategic framework

More online baesystems.com



Cyber & Intelligence

Segmental review continued

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 financial security activities.

Intelligence & Security comprises the three US-based Intelligence & Security businesses.

Air Force Solutions focuses on providing the US Air Force and its combatant commands with innovative solutions to help to modernise, maintain, test, and cyber-harden aircraft, radars, missile systems, and mission applications that detect and deter threats to national security.

Integrated Defense Solutions provides the US Army, Navy, and federal civilian markets with systems engineering, integration and sustainment services for C4ISR systems and enterprise IT networks that enhance mission effectiveness. Our solutions are deployed across platforms and networks in the air, maritime, land and cyber domains.

Intelligence Solutions provides innovative mission-enabling solutions and services to enhance the collection, analysis, and processing of data across US civilian and military intelligence communities. Our business also develops and deploys high-assurance networks that facilitate the secure sharing of data amongst intelligence agencies in support of national security.

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. Our solutions are delivered as licensed technologies, software-as-a-service subscriptions, through outsourced managed services, and via consulting and systems integration projects.

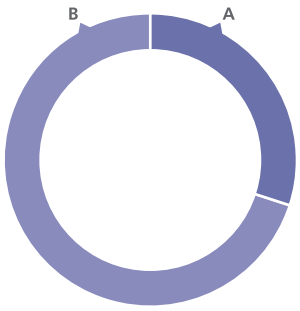
Government is focused on delivering national security and intelligence solutions to the UK and allied international governments. The business also delivers enterprise-level data and digital services to UK government departments.

Financial Services delivers anti-fraud and regulatory compliance solutions to banking and insurance customers across Europe, North America, the Middle East, Africa and Asia-Pacific.



Sales by business

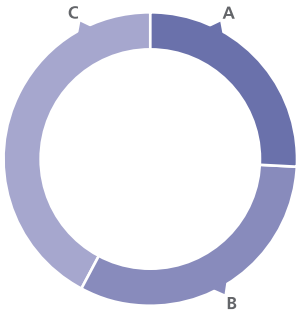
(%)



A	Applied Intelligence	30%
B	Intelligence & Security	70%

Sales by line of business: Intelligence & Security

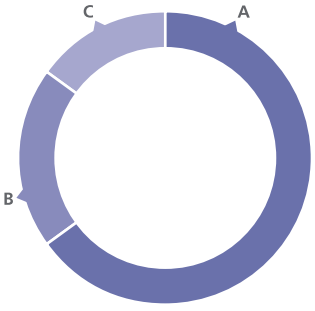
(%)



A	Air Force Solutions	26%
B	Integrated Defense Solutions	32%
C	Intelligence Solutions	42%

Sales analysis: Applied Intelligence

(%)



A	Government	65%
B	Financial Services	20%
C	Technology & Commercial	15%

Operational and strategic key points

Intelligence & Security

- Received orders exceeding $100m (£76m) to provide logistics sustainment support to US Air Force Space Command.
- Awarded $437m (£330m) task order to provide open source support to US Army and Army Intelligence & Security Command approved partners.
- Technology offerings further developed and the business achieved four Amazon Web Services designations, recognising our technical proficiency and operational excellence.

Applied Intelligence

- Divestment of the Silversky business and exit from the UK-based Managed Security Services business in progress at year-end. Restructuring charge of £20m recognised in the year.
- Strong order intake and revenue growth in the Government business unit.

Employees[1]

10,100

Financial performance

Financial performance measures as defined by the Group

		2019	2018
Sales	KPI	**£1,732m**	£1,678m
Underlying EBITA	KPI	**£91m**	£111m
Return on sales		**5.3%**	6.6%
Operating business cash flow	KPI	**£68m**	£85m
Order intake[1]	KPI	**£1,846m**	£1,802m
Order backlog[1]		**£1.8bn**	£1.9bn

- In aggregate, sales were broadly unchanged on a constant currency basis at $2.2bn (£1.7bn). Sales in the US business were 2% lower owing to customer awards made but subsequently protested. In the Applied Intelligence business, sales were up 4%, all arising in the Government business line.
- Return on sales in the US business was in line with the prior year at 9.1%. Within Applied Intelligence, the business recorded a loss of £20m following the restructuring charge taken in the first half of the year.

Financial performance measures defined in IFRS[2]

	2019	2018
Revenue	**£1,732m**	£1,678m
Operating profit	**£80m**	£59m
Return on revenue	**4.6%**	3.5%
Cash flow from operating activities	**£99m**	£96m

- Disposal of the Silversky business and exit from the UK-based Managed Security Service are expected in the near future, both of which will improve profitability in future years.
- As expected, order backlog was stable at $2.3bn (£1.8bn), after adjusting for the expected Applied Intelligence disposals.

Sales

£1,732m

06 Alternative performance measure definitions

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

Cyber & Intelligence

Segmental review continued

Operational performance

Intelligence & Security

Air Force Solutions

We received orders exceeding $100m (£76m) to provide logistics sustainment support to US Air Force Space Command for instrumentation tracking (radar, telemetry and optics) systems, which includes 26 agencies across the US Department of Defense, Department of Energy, National Aeronautics and Space Administration, plus six foreign governments.

On the US Air Force Intercontinental Ballistic Missile Integration Support Contractor Program, we were awarded a sole-source modification to increase the contract ceiling by $93m (£70m) to $1.1bn (£0.8bn). The period of performance remains through to January 2022, and our work includes programme management, systems engineering, integration and testing, sustainment and cyber defence.

Integrated Defense Solutions

We are executing the fourth year of a five-year, $368m (£278m) sole-source contract to support weapons systems on board US Ohio and UK Vanguard Class submarines, as well as future US Columbia Class and UK Dreadnought Class submarines.

The US Navy has awarded the business a five-year Indefinite Delivery, Indefinite Quantity (IDIQ) contract with an expected lifecycle value of $280m (£211m) to modernise and maintain command, control, communications, computers, cyber, intelligence, surveillance and reconnaissance systems aboard new construction aircraft carriers and large deck amphibious ships.

We secured a $126m (£95m) contract for the US Marshals Service (USMS), a component of the US Department of Justice. The business will provide mission-critical IT infrastructure support, sustainment operations and engineering services to the USMS Information Technology Division.

The business has been awarded a $300m (£227m) contract to provide enterprise and mission-critical IT support to the Federal Emergency Management Agency's Operations and Maintenance Division. The programme will provide IT infrastructure modernisation, system sustainment and telecommunications, network and helpdesk services.

We were awarded a $212m (£160m) US Navy follow-on contract for the design, acquisition, integration and test of radio communication suites for Guided Missile Destroyers and other US Navy and Coast Guard ships. This win continues our near 50-year legacy as an integrator of mission-critical shipboard systems.

The business was awarded a five-year, $200m (£151m) contract to provide systems engineering, security management, modelling and simulation, and training services to help in the US government defence cyber mission.

Intelligence Solutions

The team is executing on a number of task order contracts valued at approximately $320m (£242m) to provide motion-imagery analysis, training, and research support services to the US intelligence community, and provide technical, functional, and general support to enhance the situational awareness and training of US Army troops deployed around the world.

A $70m (£53m) engineering change proposal was secured, extending the period of performance on a contract originally awarded in 2013 to provide high-performance computing and infrastructure support to the US intelligence community.

The business was awarded a significant follow-on contract and a new award with a combined value of over $490m (£370m) to provide critical intelligence support to the US government.

We were awarded a new $437m (£330m) task order to provide open source support for the Army and Army Intelligence & Security Command approved partners, to provide training, policy and governance recommendations, assessments and implementation of emerging capabilities, and to establish and manage a secure cloud hosting environment for these efforts.

The business was awarded a prime position on Solutions for Intelligence Analysis 3, a ten-year multiple award IDIQ contract. The company will provide worldwide coverage, support and assistance to the Defense Intelligence Agency delivering timely, objective and cogent military intelligence to defence planners and policy makers.

We are delivering our first Federated Secure Cloud implementation, supporting multiple independent levels of security, and leveraging this capability into adjacent customers. In addition, the business has established multiple commercial cloud partnerships to drive additional services revenue across defence and intelligence customers.

Among a number of strategic developments in 2019, the business furthered its technology offerings and attained Amazon DevOps, Government and Disaster Response and Public Safety Competencies, as well as being named an Amazon Web Services Premier Consulting Partner.

Applied Intelligence

As at the 2019 year-end, negotiations relating to the disposal of the US-based software-as-a-service business were ongoing.

Government

The Government business delivered good growth in orders. Performance was particularly strong in UK National Security which benefited from the signing of a number of transformational multi-year deals. Revenue growth followed the higher order intake, with increased headcount and continuing investment in talent in a competitive labour market for highly-skilled software engineers with enhanced security clearances. Profitability continued to benefit from cost control and greater efficiency in sales and management activity in the International business in particular.

Financial Services

The Financial Services business has seen a significant increase in business development investment in the year. The higher spend on product engineering culminated in the launch of a new version of NetReveal®, v8.0, in the first half of the year. Response to the product has been positive and has led to a number of pipeline opportunities for upgrades to existing customers and deployment to new customers. The conversion of these opportunities drove order intake growth in the second half of the year and positions the business for higher levels of growth in the future.

Looking forward

Forward-looking information for the Cyber & Intelligence reporting segment is provided later in this report.

74 Segmental looking forward



Our strategy in action

Partnering to build trusted cloud and cyber capabilities

In 2019, we established new partnerships and expanded upon existing relationships with commercial technology companies aimed at further establishing our cloud and cyber capabilities.

By achieving four new Amazon Web Services (AWS) designations – Government Competency, DevOps Competency, Disaster Response & Public Safety Competency, and Premier Consulting Partner – our people and processes have been recognised for outstanding innovation.

These trusted, independent accreditations of our technical proficiency and operational excellence prove we understand the mission and are a valued partner of AWS in their cloud operations. As a valued partner, we've joined an exclusive group of organisations with access to cutting-edge innovations and groundbreaking collaboration efforts that enable us to address our customers' most pressing IT needs. This AWS connection also helps us to scale and optimise the security solutions we provide to the US defence and intelligence communities, leveraging the latest technology to support their missions.

18 Group strategic framework

More online
baesystems.com

Platforms & Services (US)

Segmental review continued

Platforms & Services (US), with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including naval ship repair, and the management and operation 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 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 and operation of the US Army's Holston and Radford facilities.

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

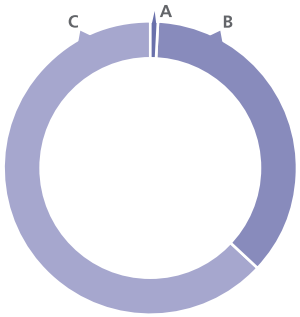
BAE Systems Hägglunds focuses on the tracked vehicle market for Swedish and international customers.

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



Sales by domain

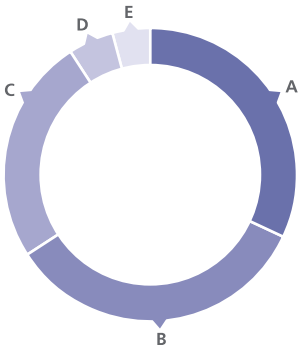
(%)



A	Air	1%
B	Maritime	36%
C	Land	63%

Sales by line of business

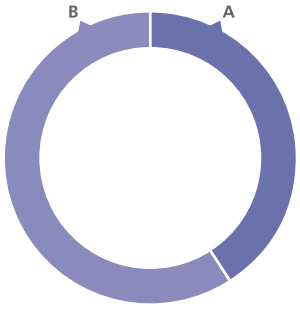
(%)



A	US Combat Vehicles	32%
B	Weapon Systems	34%
C	US Ship Repair	25%
D	BAE Systems Hägglunds	5%
E	FNSS	4%

Sales analysis: Platforms and services

(%)



A	Platforms	41%
B	Services	59%

Operational and strategic key points

- Deliveries of the M109A7 self-propelled howitzer and ammunition carrier vehicle sets are progressing and the decision to proceed to full-rate production was made in Q1 2020.
- First deliveries achieved of the Amphibious Combat Vehicle to the US Marine Corps.
- Contract modification award of $575m (£434m) received for LRIP vehicles on the Armored Multi-Purpose Vehicle programme.
- Work underway to upgrade 332 vehicles to the Bradley A4 configuration.
- Awarded contracts worth $466m (£352m) to upgrade configuration on various M88 vehicles.
- First tandem docking of two large warships in San Diego dry-dock for contracts worth more than $170m (£128m).
- Deliveries continue of the M777 ultra-lightweight howitzer to the Indian Army, with subsequent systems to be assembled at the Mahindra Defence Systems facility.

Employees[1]

12,500

Financial performance

Financial performance measures as defined by the Group

		2019	2018
Sales	KPI	**£3,337m**	£3,005m
Underlying EBITA	KPI	**£267m**	£210m
Return on sales		**8.0%**	7.0%
Operating business cash flow	KPI	**£241m**	£(30)m
Order intake[1]	KPI	**£4,020m**	£3,693m
Order backlog[1]		**£5.8bn**	£5.4bn

Financial performance measures defined in IFRS[2]

	2019	2018
Revenue	**£3,185m**	£2,864m
Operating profit	**£239m**	£161m
Return on revenue	**7.5%**	5.6%
Cash flow from operating activities	**£305m**	£31m

- Sales in the year were up 6% to $4.3bn (£3.3bn), within guidance. In the US Combat Vehicles business, the second half challenge to deliver the ramp up in M109A7 deliveries was met.
- Return on sales performance for the year improved to 8.0% with no material charges taken in the year. As regards the ramp in Combat Vehicles sales, we are trading profit on the Armored Multi-Purpose Vehicle and Amphibious Combat Vehicle programmes at an initial low level.
- Cash flow performance was very strong in the second half of the year as vehicle production deliveries increased and working capital was liquidated.
- Order backlog was further increased to $7.7bn (£5.8bn), with total in-year funded Combat Vehicle orders received of $2.5bn (£1.9bn).

Sales

£3,337m

06 Alternative performance measure definitions

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

Platforms & Services (US)

Segmental review continued

Operational performance

US Combat Vehicles

The business continues to make progress towards achieving consistent production throughput across multiple programmes with the implementation of ongoing improvements and investments in modernising facilities and manufacturing technologies, including automation and robotic welding.

We are leveraging the lessons learned on the M109A7 programme and continue to integrate innovative manufacturing capabilities during the early stages of the production of new combat vehicles. While schedule adjustments have been necessary, addressing these challenges will facilitate consistency of quality and delivery for our customers, and bring long-term benefits across our vehicle programmes.

Initial Amphibious Combat Vehicles (ACVs) were delivered to the US Marine Corps under Low-Rate Initial Production (LRIP), with a third LRIP contract received in October bringing the total value to $458m (£346m) for 90 vehicles. Under a $67m (£51m) contract awarded in June, we have begun design and development activities on two new mission variants of the ACV family of vehicles.

As one of two competitors, we continue to work on the US Army's Mobile Protected Firepower programme under a $376m (£284m) contract for the engineering and manufacturing development phase for rapid prototyping efforts.

On the US Army's Armored Multi-Purpose Vehicle programme, we were awarded a $575m (£434m) contract modification, bringing the cumulative award value to $873m (£659m). Initial LRIP vehicles are scheduled to begin delivery in 2020.

We continue to progress the LRIP phase of the M109A7 programme, with contracts in 2018 and 2019 totalling approximately $750m (£566m) for 108 vehicle sets. These cumulative LRIP awards include the recent December contract modification and long-lead material funding. The decision to proceed to full-rate production was subsequently made in the first quarter of 2020. In July, we received a $45m (£34m) contract to support the integration of the Extended Range Cannon Artillery on the M109A7 to double the range of the gun system, which is among the Army's top priorities.

Work has begun under contracts for 332 vehicles, valued at $578m (£437m) to upgrade to the Bradley A4 configuration.

We continue to work on US Army contracts for production and sustainment of M88 recovery vehicles, to include upgrades from the M88A1 to the M88A2 HERCULES configuration. In September we received a $148m (£112m) contract to upgrade an additional 43 vehicles, and were competitively selected for a $318m (£240m) contract to upgrade to the next-generation M88A3 configuration to restore single-vehicle recovery.

Internationally, the delivery of an additional 11 Assault Amphibious Vehicles for Japan was completed in the second half of the year and work continues on 36 vehicles for Taiwan. The delivery of 32 M109A5+ self-propelled howitzers to the Brazilian Army was completed in the second half of the year.

Weapon Systems

Deliveries of M777 ultra-lightweight howitzers continue to the Indian Army under a $542m (£409m) Foreign Military Sale contract for 145 M777s. The initial guns are being built in our facilities, with at least 120 subsequent systems to be assembled in India at Mahindra Defence Systems' new facility.

We received two orders totalling $85m (£64m) from the US Navy to deliver six Mk45 Mod 4 gun systems, providing a solid US Navy order book of 20 Mk45 systems. We are also delivering 57mm Mk110 gun systems to the US Navy and Coast Guard, with nearly 60 systems now delivered to US maritime forces.

We continue to execute on contracts for 155mm BONUS ammunition to the Swedish Army and the US Army. Under a 2016 contract modification, we are providing 24 additional ARCHER artillery systems to the Swedish government, and we are under multiple export contracts to deliver 40 Mk4 and 57 Mk3 naval gun systems.

We continue to perform on a $183m (£138m) contract to provide the Maritime Indirect Fire System for the UK Royal Navy's Type 26 frigate, which includes Mk45 Mod 4 gun systems, automated ammunition handling systems and gun fire control systems.

Under the latest contract awarded in March, we are to produce 28 more Virginia Payload Module tubes for the US Navy's Block V Virginia-class submarines.

Ordnance Systems

We manage, operate and modernise the US Army's Radford and Holston munitions facilities.

At Holston, production operations impacted by a fire in January 2019 resulted in a £10m charge recognised in the HQ segment under the Group insurance arrangement. Modernisation activities continue under multiple contracts to construct a natural gas-fired steam facility, a waste water management facility that is nearing completion, as well as the design, construction and commissioning of new production facilities to improve efficiency and modernise energetics manufacturing.

At Radford, in addition to ongoing operations, work continues on the construction of a modernised nitrocellulose facility, and we are actively managing ongoing subcontractor performance issues, cost and schedule overruns, and related disputes.

US Ship Repair

Our US maintenance and modernisation shipyards remain in strong demand. In 2019, we secured orders across our US shipyards totalling approximately $1bn (£0.8bn), including awards to service the USS The Sullivans in Jacksonville and the USS Vicksburg in Norfolk.

In September, we received two contracts totalling more than $170m (£128m) for the repair and maintenance of the guided-missile destroyers USS Stethem and USS Decatur in San Diego, resulting in the first tandem docking of two large warships in our San Diego dry-dock.

Following a thorough analysis of the new Multiple Award Contract structure being implemented in Pearl Harbor, Hawaii, we informed the Navy we will not bid for future work in Hawaii, and will focus on completing existing contracts.



Our strategy in action

Two destroyers, one dry-dock

In October, our San Diego Ship Repair business put two US Navy guided-missile destroyers into its dry-dock simultaneously, accomplishing the massive feat on a scale that had previously never been achieved in the port.

The USS Stethem and USS Decatur were lifted out of the water under combined contracts worth $171m (£129m) and are scheduled to remain in the dry-dock until April 2020. Each ship displaces 9,000 tons and is more than 500 feet long. This tandem docking capacity was made possible with the introduction into operations of our 55,000-ton dry-dock in 2017 – an investment to achieve precisely this critical capability and help the US Navy to meet its maintenance requirements and return the ships more efficiently back to the fleet.

18 Group strategic framework

More online
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BAE Systems Hägglunds

With an installed base of nearly 1,300 CV90 vehicles in Sweden and across six other international markets, the business continues to pursue contractual opportunities, including the Czech Republic's competition to replace its fleet of BMP2 Infantry Combat Vehicles.

Work is progressing to refurbish Swedish CV90s, and initial deliveries have begun on the integration of 40 Mjölner mortar systems under a separate contract. We were selected by the Dutch Army to integrate the Elbit Systems' Iron Fist Active Protection System on its fleet of CV90s.

32 BvS10 all-terrain vehicles under contract for Austria were delivered for final acceptance.

FNSS

FNSS, our land systems joint venture based in Turkey, continues to perform under its $524m (£396m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army. Deliveries continue under a contract with Oman for PARS wheeled armoured vehicles in 8x8 and 6x6 configurations.

Work progresses under multiple contracts for the Turkish Armed Forces, including a €278m (£236m) contract for 260 anti-tank vehicles, an €84m (£71m) contract for air defence vehicles, a €155m (£131m) contract for 27 assault amphibious vehicles, and a contract worth €154m (£131m) for 100 special purpose 8x8 and 6x6 vehicles.

Looking forward

Forward-looking information for the Platforms & Services (US) reporting segment is provided later in this report.

75 Segmental looking forward



Air

Segmental review continued

Air comprises the Group's UK-based air activities for European and International Markets, and US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture.

Our **UK-based** business includes programmes in European and International Markets for the production of Typhoon combat and Hawk trainer aircraft, support and upgrades for Typhoon, Tornado and Hawk aircraft, and development of next-generation Air Systems and defence information systems, as well as US Programmes, primarily the UK-based F-35 Lightning II manufacture, engineering development and support activity.

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 primarily delivers 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.

The Type 26 frigate was selected for the Commonwealth of Australia's Hunter Class nine-ship Future Frigate programme, with a framework agreement including the scope for the initial design and productionisation phase signed in December 2018.

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

Technology

Underpinning the Air strategy is a set of technology and capability enablers which allow BAE Systems to invest in evolving today's portfolio and create a pathway to future products and services, an example of this is our PHASA-35™ product (see page 69). Our ambitious vision of providing capable, affordable, flexible system of systems across the air, space, cyber and information space, is underpinned by an investment in key technologies that ensure our processes and facilities, from digital twins, to additive manufacturing, augmented reality, artificial intelligence and collaborative robotics, are fit for the future.

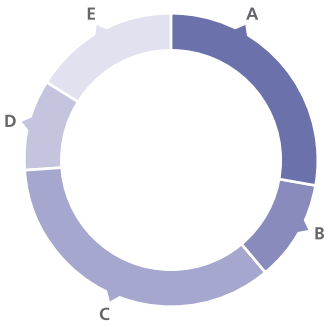
Our investment into the Laser Directed Energy Weapons area is in assessing disruptive effect technologies for use in future operations. Our investment in Reaction Engines Limited is testing the market opportunity for hypersonic-related technology applications. We are also investing in our infrastructure through our high-tech factory of the future and our evolving Air Labs and Air Works capability that looks to improve the schedule and cost performance across our design, manufacturing and support lifecycle.

In this era of rapid technological change, our engagement with innovators from across defence, commerce, government and academia seeks to quickly mature technology applications that deliver a competitive edge though our strategic technology investments.



Sales by line of business

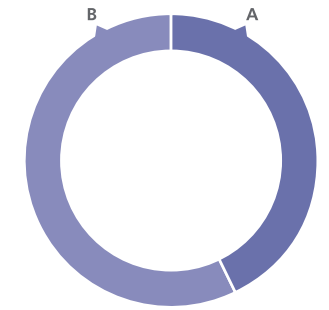
(%)



A	European and International Markets	28%
B	US Programmes	11%
C	Saudi Arabia	35%
D	Australia	10%
E	MBDA	16%

Sales analysis: Platforms and services

(%)



A	Platforms	43%
B	Services	57%

Operational and strategic key points

- Qatar Typhoon and Hawk aircraft programme met its contractual milestones in the year. Contract amendment agreed to accelerate Typhoon deliveries.
- F-35 programme Lots 12 to 14 price negotiations concluded. 142 rear fuselage assemblies delivered in the year in line with ramp-up to full rate production in 2020.
- Tempest technology maturation programme contracted between industry and UK government. Italy and Sweden governments committed to working with UK to develop next-generation combat air capability.
- The first four Hawk aircraft assembled in Saudi Arabia were accepted and entered service in-Kingdom.
- UK Tornado fleet successfully retired from service on schedule following RAF declaration that Typhoon had met Centurion standard with embodiment across the Typhoon fleet.
- The design and production readiness phase of the Hunter Class programme for the Royal Australian Navy continues to make good progress.

Employees[1]

28,300

Financial performance

Financial performance measures as defined by the Group

		2019	2018
Sales	KPI	**£7,457m**	£6,712m
Underlying EBITA	KPI	**£887m**	£859m
Return on sales		**11.9%**	12.8%
Operating business cash flow	KPI	**£408m**	£666m
Order intake[1]	KPI	**£4,594m**	£14,845m
Order backlog[1]		**£23.9bn**	£27.4bn

Financial performance measures defined in IFRS[2]

	2019	2018
Revenue	**£6,153m**	£5,579m
Operating profit	**£777m**	£810m
Return on revenue	**12.6%**	14.5%
Cash flow from operating activities	**£497m**	£719m

- Sales were up 11% at £7.5bn. As expected there was higher production activity on the new Typhoon and Hawk programme for Qatar, and the F-35 programme continues to ramp up towards full rate next year. In addition sales from MBDA grew on deliveries to Egypt and Qatar.
- The return on sales of 11.9% was ahead of expectations on strong programme execution. It reflects low initial profit recognition on the early stages of the Qatar programme, and increased self-funded research and development on the Tempest future combat air development. Last year's return on sales benefited by 70bps from the completing Oman Typhoon contract.
- Cash flow largely reflects the utilisation of provisions, timing on receivables, and the difference between joint venture profits and cash dividends received. There was also some usage of prior year Qatar funding.
- Order backlog reduced to £23.9bn, primarily for the trading on multi-year orders, received in prior years, for the Saudi Arabian support and Qatar programmes.

Sales

£7,457m

06 Alternative performance measure definitions

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

Air

Segmental review continued

Operational performance

European and International Markets

Mobilisation activity on the 24 Typhoon and nine Hawk aircraft and associated support and training contract for the Government of the State of Qatar has progressed to plan with all initial milestones achieved. A contract amendment was agreed during the year accelerating Typhoon deliveries and contract milestones.

The first eight of 28 major units on the Kuwait Typhoon contract, secured by Italian Eurofighter partner Leonardo, have been delivered. The remaining major units are planned for delivery by 2022.

In the year, the Royal Air Force accepted the final three Typhoon aircraft from the UK final assembly facility. The German, Italian and Spanish Air Forces accepted a total of 11 aircraft in 2019, leaving one of the 88 Tranche 3 aircraft to be delivered.

Following the declaration by the Royal Air Force that Typhoon had met Centurion standard in December 2018, enabling the transition of capabilities from Tornado to Typhoon, the UK Tornado fleet successfully retired from service on schedule. Centurion standard has now been embodied across the Typhoon fleet.

In the UK, under a ten-year partnership arrangement, and in Oman, under a five-year availability service contract, we continue to support Typhoon fleets to achieve customer target flying hours. BAE Systems continues to support the European Partner Nations' own support arrangements.

Support to the Royal Air Force's UK fleet of Hawk fast jet trainer aircraft continues through the long-term availability contract. We are in discussions with the UK on future Hawk support arrangements and we continue to support users of Hawk trainer aircraft around the world.

The next phase of the Tempest technology maturation programme was contracted between industry and the UK government. This was followed by the signing of a Memorandum of Understanding between the UK and Sweden in July, and a Statement of Intent between the UK and Italy in September, committing the respective governments to working with the UK government to develop next-generation combat air capability.

Progress continues on the collaboration for the design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force.

US Programmes

On the F-35 programme, price negotiations on Lots 12 to 14 concluded in the second half of 2019 and the business is ramping up to full-rate production by the end of 2020. In the period, 142 rear fuselage assemblies were delivered under the Low-Rate Initial Production contracts for Lots 11 to 13, bringing total deliveries on the programme to over 600.

At RAF Marham in the UK, following the declaration of Initial Operational Capability in 2018, we continue to support the customer in integrating the F-35 into its operational fleet and forward deployments.

BAE Systems continues to play a growing role on the F-35 sustainment programme including the supply of spares and technical support, software products, upgrades and specialist manpower services.

Saudi Arabia

The Group is reliant on the continued approval of export licences by a number of governments in order to continue supplies to the Kingdom of Saudi Arabia. Following extensions being granted by the German government to a number of export licences on joint collaborative programmes, we are working closely with industry partners and the UK government to continue to fulfil the contractual support arrangements in Saudi Arabia on the key European collaboration programmes.

In June 2019, the Court of Appeal of England and Wales directed the Secretary of State for International Trade to revisit the decision-making process for granting export licences for the sale of military equipment to the Kingdom of Saudi Arabia for possible use in the conflict in Yemen and to retake its decisions regarding such licences on that basis. The Company will assess the result of the retaking by the Secretary of State of such decisions, once they have been made. Pursuant to the Order of the Court, the Secretary of State undertook not to grant new licences for the export of arms or military equipment to Saudi Arabia for possible use in the conflict in Yemen until such decisions have been retaken. Both the Secretary of State and the other party to the proceedings have sought and obtained permission to appeal the Court's ruling to the Supreme Court.

In March 2018, the UK and the Kingdom of Saudi Arabia signed a Memorandum of Intent for the supply of a further 48 Typhoon aircraft, support and transfer of technology and capability. This would enable BAE Systems to continue with the localisation of defence capabilities in Saudi Arabia. Final assembly of all 48 Typhoon aircraft would be in-Kingdom.

The business continues to perform against the contract secured in 2018 to provide Typhoon support services to the Royal Saudi Air Force through to 2022.

The Saudi British Defence Co-operation Programme five-year funding agreement through to 2021 comprises a number of contracts, including support to the Tornado fleet and provision of Officer and Aircrew Training for the Royal Saudi Air Force, as well as engineering and logistics services for the Royal Saudi Naval Forces. These services continue to progress well. Previous issues relating to the availability of the Hawk trainer aircraft have been addressed and the aircraft availability is now consistent with the contractual requirements.

Four Hawk aircraft assembled in-Kingdom have been accepted and entered service with the Royal Saudi Air Force in the year. The company has delivered all of the 22 major units to meet this final assembly programme.

Work continues to reorganise our portfolio of interests in a number of industrial companies in Saudi Arabia. Riyadh Wings Aviation Academy LLC increased its ownership in 2019 to 23.5% in the Group's Overhaul and Maintenance Company (OMC) subsidiary. Additionally during the year OMC disposed of its 85.7% shareholding in Aircraft Accessories and Components Company. Following OMC entering into a heads of terms for the sale of its 50% shareholding in Advanced Electronics Company to Saudi Arabian Military Industries (SAMI), negotiations are continuing and the transaction is expected to take place in the first half of 2020.

Through the restructuring of the Group's portfolio of interests in its Kingdom of Saudi Arabia industrial companies, along with transformation activities to transfer local capability into these companies, we are working in partnership with SAMI to explore how we can collaborate to deliver further In-Kingdom Industrial Participation, in line with the Kingdom's Vision 2030.

Australia

The initial design and production readiness phase of the Hunter Class programme for the Royal Australian Navy continues to make progress, and the integration of ASC Shipbuilding into our Australian operations is progressing well. The first Integrated Baseline Review on the programme is expected to be completed in Q2 2020.

Progress continues on the Jindalee Operational Radar Network upgrade contract secured in 2018 from the Commonwealth of Australia, with the System Requirements Review completed and the first tranche programme baseline under review. On the sustainment contract, support to the three radar sites continues to see all operational milestones being achieved to plan.

Final acceptance of the Royal Australian Navy's two Landing Helicopter Docks is expected to be in 2020. Responsibility for future support has now been fully transitioned to Naval Ship Management.

Progress on the sustainment and upgrade of the Anzac fleet under the Warship Asset Management Alliance continues with the first of class, HMAS Arunta, now deployed back to operations. The second vessel, HMAS Anzac, has now undocked.

The Hawk Mk127 Lead-In Fighter project did not meet all aircraft availability requirements for the year. The pilot training programme however, was for the most part not impacted. The upgrade of the Hawk fleet to meet the F-35 training requirements has been completed.

Sustainment activity continues for the regional F-35 fleet at our Williamtown facility, with 13 aircraft now on base.

We were notified in September that we had been unsuccessful in our bid for the Land 400 Phase 3 Combat Vehicle programme.

MBDA

During 2019, MBDA secured development contracts for Enhanced Modular Air Defence Solutions in Italy and for Enforcer missile systems in Germany. Further contracts for Meteor were secured for additional tranches in France and Germany, as well as an integration contract for the South Korean KF-X fighter aircraft. Other contract awards include ASRAAM for Typhoon in Oman and in Qatar (the latter having already ordered Meteor and Brimstone) and a number of key support contracts for both European domestic and international customers.

In June, the MBDA/Lockheed Martin joint venture submitted to the German customer the updated TLVS (Ground-Based Air Defence System) proposal.

Good progress has been made on a number of development programmes including: the next-generation MICA missile; Spear Capability 3; and Aster Block 1 New Technology. In addition, the Future Cruise/Anti-Ship Weapon (the Anglo/French co-operation programme to replace Storm Shadow/Harpoon in the UK and SCALP/Exocet in France) has successfully achieved its concept review, an important step in the decision to launch the following phases of the programme. Progress has also continued on production programmes, notably MICA missile deliveries for a number of international customers.

Looking forward

Forward-looking information for the Air reporting segment is provided later in this report.

75 Segmental looking forward

Our strategy in action

Pushing technological boundaries

As part of our strategy to develop breakthrough technologies, in 2019 we reached an agreement to acquire Prismatic Ltd.

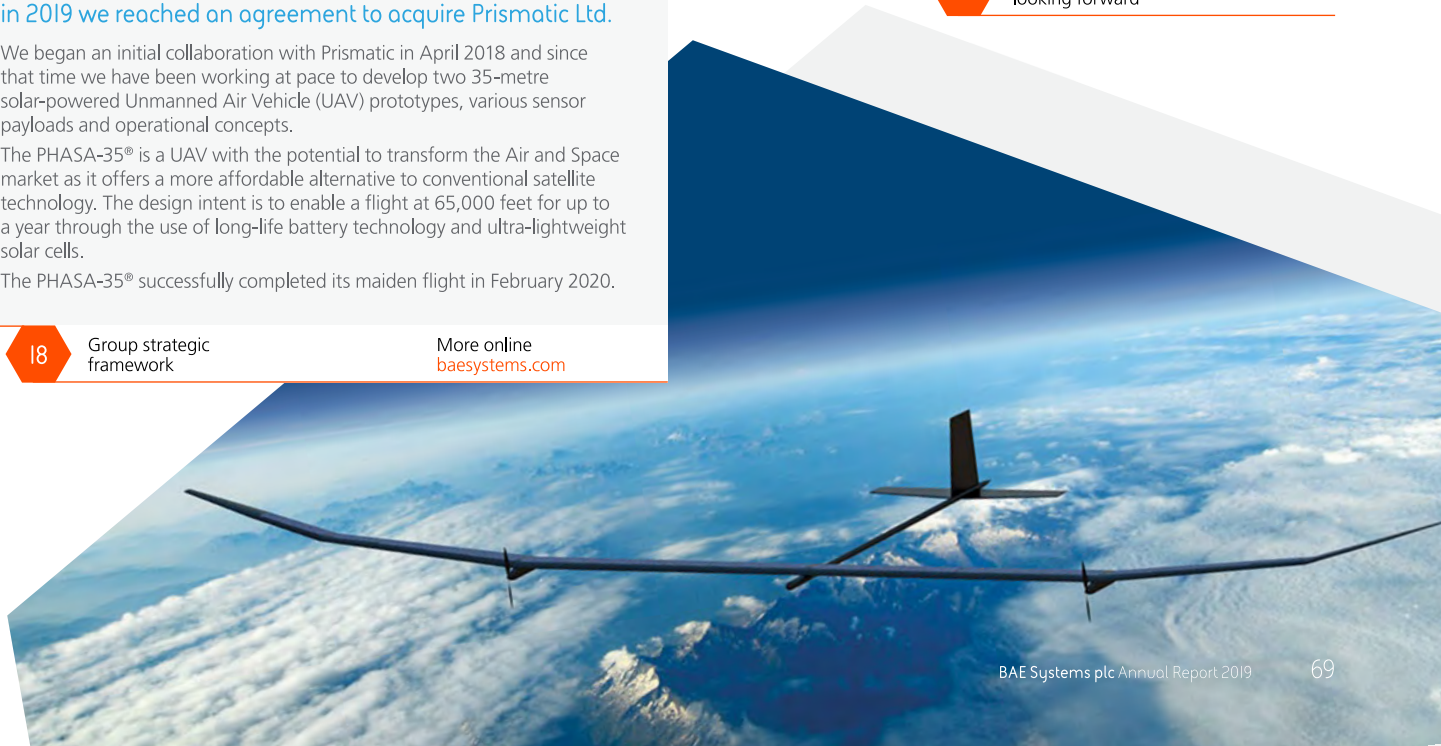
We began an initial collaboration with Prismatic in April 2018 and since that time we have been working at pace to develop two 35-metre solar-powered Unmanned Air Vehicle (UAV) prototypes, various sensor payloads and operational concepts.

The PHASA-35® is a UAV with the potential to transform the Air and Space market as it offers a more affordable alternative to conventional satellite technology. The design intent is to enable a flight at 65,000 feet for up to a year through the use of long-life battery technology and ultra-lightweight solar cells.

The PHASA-35® successfully completed its maiden flight in February 2020.

18 Group strategic framework

More online baesystems.com



Maritime

Segmental review continued

Maritime comprises the Group's UK-based maritime and land activities.

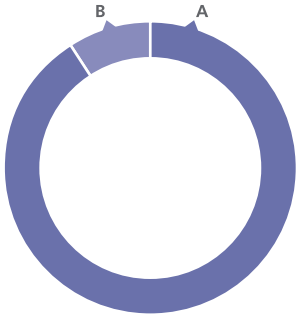
Maritime programmes include the construction of the two Queen Elizabeth Class aircraft carriers, five River Class Offshore Patrol Vessels and seven Astute Class submarines for the Royal Navy, as well as the design and production of the Royal Navy's future Dreadnought Class submarine and Type 26 frigate. Additionally the Maritime portfolio includes in-service support, including the delivery of training services and management of HM Naval Base Portsmouth and the design and manufacture of combat systems, torpedoes and radars.

Land UK designs, develops and manufactures a comprehensive range of munitions products servicing its main customer, the UK Ministry of Defence, as well as international customers. In July 2019, the business formed a joint venture with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Land UK also develops and manufactures cased-telescoped weapons through its CTA International joint venture.



Sales by domain

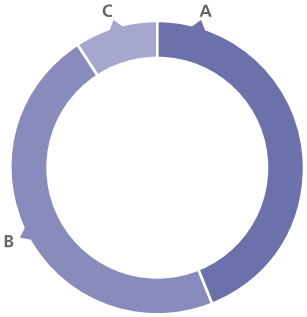
(%)



A	Maritime	**91%**
B	Land	**9%**

Sales by line of business

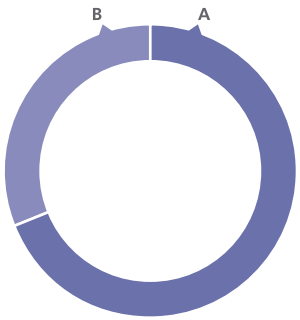
(%)



A	Naval Ships	**44%**
B	Submarines	**47%**
C	Land UK	**9%**

Sales analysis: Platforms and services

(%)



A	Platforms	**69%**
B	Services	**31%**

Operational and strategic key points

- HMS Prince of Wales vessel acceptance achieved in December.
- Four River Class Offshore Patrol Vessels have now been accepted, with the programme on target for completion in 2020.
- Construction commenced on second of the three contracted Type 26 frigates in August.
- Construction of the first Dreadnought Class submarine continues to advance, with £1.4bn of funding received in the year.
- Sea trials for the fourth Astute Class submarine are due to take place in 2020.
- A £230m seven-year Torpedo Repair and Maintenance contract was awarded.
- The UK combat vehicles joint venture between Rheinmetall and BAE Systems Land UK was launched on 1 July.
- Design requirements for the Canadian Surface Combatant are progressing towards finalisation with partners and the Royal Canadian Navy.

Employees[1]

16,300

Financial performance

Financial performance measures as defined by the Group

		2019	2018
Sales	KPI	**£3,116m**	£2,975m
Underlying EBITA	KPI	**£268m**	£209m
Return on sales		**8.6%**	7.0%
Operating business cash flow	KPI	**£150m**	£67m
Order intake[1]	KPI	**£2,875m**	£3,513m
Order backlog[1]		**£8.6bn**	£9.0bn

Financial performance measures defined in IFRS[2]

	2019	2018
Revenue	**£3,071m**	£2,940m
Operating profit	**£253m**	£191m
Return on revenue	**8.2%**	6.5%
Cash flow from operating activities	**£289m**	£190m

- Sales in the Maritime businesses were up 5%, ahead of guidance, at £3.1bn. Whilst the Dreadnought submarine and Type 26 programmes continue to ramp up, the Carrier and Offshore Patrol Vessel programmes are close to completion. Activity levels in Portsmouth Naval Base support remained strong through the year.
- Return on sales was at 8.6%, within our guidance range.
- The operating cash inflow of £150m reflects utilisation of the Naval Ships provision created last year and the completion of the Carrier programme.
- Order backlog has reduced slightly to £8.6bn, with further awards for funding on the Dreadnought programme outweighed by trading on the Astute, Carrier and Type 26 programmes.

Sales

£3,116m

06 Alternative performance measure definitions

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

Maritime

Segmental review continued

Operational performance

Maritime

Naval Ships

The second Queen Elizabeth Class aircraft carrier, HMS Prince of Wales, departed Rosyth in September to undertake comprehensive sea trials before entering Portsmouth for the first time in November and being accepted in December. The first Queen Elizabeth Class aircraft carrier, HMS Queen Elizabeth, celebrated a significant milestone in October with the first UK F-35s landing on board for operational trials, with HMS Dragon, the BAE Systems-designed and manufactured Type 45 destroyer, escorting.

Four of the five River Class Offshore Patrol Vessels have now been accepted by the Ministry of Defence and we are working to a schedule which would see programme completion in 2020.

The first three City Class Type 26 frigates are on contract with construction underway on the first two ships. The programme currently employs over 2,000 people and approximately one half of the First of Class, HMS Glasgow, is under construction and she remains on track to enter service in the mid-2020s. Work continues on the second ship, HMS Cardiff, following the formal start of full-scale manufacture in August. Investment in site infrastructure in our Glasgow shipyards continues with dock readiness works progressing well and new office space to be completed in early 2020.

Following the success of the Global Combat Ship design in Australia and Canada both programmes are gaining momentum as teams are mobilised. Work continues to transfer product and process knowledge, share experiences of complex operations and help to prepare the organisation in Australia for the transition of delivery responsibility. We are working closely with our partners and the Royal Canadian Navy to finalise the design requirements for the Canadian Surface Combatant.

Submarines

BAE Systems is a member of the Dreadnought Alliance, working alongside the Submarine Delivery Agency and Rolls-Royce to deliver a replacement for the Royal Navy's Vanguard class, which carries the UK's independent nuclear deterrent. The value of the programme to the Company to date is £5.2bn, with contract funding of £1.4bn received in 2019. Four Dreadnought Class submarines will be built in Barrow, with the first of these due to be in operational service in the early 2030s. Construction of the first submarine continues to advance with many of the major pressure hull units now manufactured. The major programme of investment to redevelop the Barrow site to support the delivery of Dreadnought is well underway, with several of the new facilities now complete and in operation.

The first three Astute Class submarines are in operational service with the Royal Navy. The remaining four boats are at an advanced stage of construction. The fourth boat, Audacious, is in the final stages of testing and commissioning ahead of sea trials.

Maritime Services

Our Maritime Services business is responsible for management and maintenance of HM Naval Base Portsmouth and supports more than half of the Royal Navy's surface fleet, including the Type 45 destroyers, through the Maritime Support Delivery Framework (MSDF) contract which runs to March 2020. An 18-month extension to MSDF is due to be finalised in March 2020. In November, HMS Prince of Wales arrived at HM Naval Base Portsmouth, her home port.

The company was awarded the Torpedo Repair and Maintenance contract. This seven-year contract is worth £230m and secured over 100 highly skilled jobs at the Broad Oak site in Portsmouth.

Progress continued on the £270m Spearfish torpedo upgrade programme, with the demonstration phase forecast to complete in 2020.

The company was awarded four contracts to support the repair and maintenance of over 600 small boats operated by the Royal Navy, the Royal Marines, the Royal Fleet Auxiliary, the Army and the Ministry of Defence Police over a period of six and a half years.

Land UK

The munitions business continues to provide UK and international customers with a wide range of light and heavy munitions, as well as offering complementary support services for development, testing and evaluation. We continue to work with the UK Ministry of Defence to agree a replacement to the existing Munitions Acquisition Supply Solution partnering agreement.

In July 2019, following receipt of regulatory approvals, the business formed a joint venture with Rheinmetall, Rheinmetall BAE Systems Land (RBSL), to create a joint UK-based land vehicle design, manufacturing and support business. Rheinmetall purchased a 55% stake in the existing BAE Systems UK-based combat vehicles business for £31.5m with BAE Systems retaining 45%. This transaction did not include the Land UK munitions business or its holding in the CTA International joint venture with Nexter.

The UK Ministry of Defence has now awarded the £2.3bn contract to provide the British Army with over 500 8x8 armoured vehicles. The contract was awarded to Artec GmbH, comprising Rheinmetall and Krauss-Maffei Wegmann. Rheinmetall will subcontract approximately half the production to RBSL which will undertake vehicle structure fabrication, assembly, integration and test of the vehicles at its Telford facility.

During the year, 95 40mm cased-telescopic cannons were delivered to the Ministry of Defence by CTA International, bringing cumulative deliveries to 370. This entirely new cannon design – currently being integrated in the British Army's new Ajax and upgraded Warrior vehicles – has also been selected by the Belgian Army for its Jaguar vehicles.

Looking forward

Forward-looking information for the Maritime reporting segment is provided later in this report.

75 Segmental looking forward

Our strategy in action

Delivering next-generation naval capability

In November, HMS Prince of Wales, the second of two aircraft carriers designed and constructed for the Royal Navy, sailed into her home port of Portsmouth Naval Base for the first time, following the successful completion of her first stage sea trials nearly two weeks ahead of schedule.

It marked an important and proud milestone for everyone who has worked on the Queen Elizabeth Class programme across the UK. The ship's arrival into Portsmouth represented the culmination of 16 years of work by the Aircraft Carrier Alliance – a unique alliancing relationship between BAE Systems, Babcock, Thales and the UK Ministry of Defence. More than 10,000 people across the UK have been involved in the programme to deliver the Queen Elizabeth Class aircraft carriers, with six British shipbuilding yards across the country playing a vital role in the ships' design and construction.

18 Group strategic framework

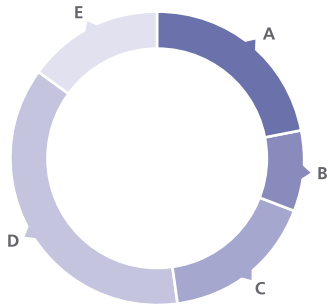
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Segmental looking forward

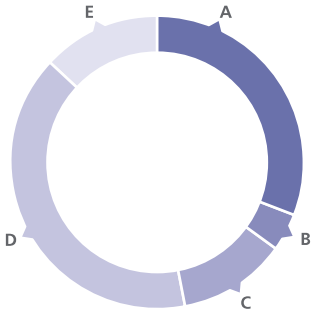
BAE Systems has five principal reporting segments, Electronic Systems, Cyber & Intelligence, Platforms & Services (US), Air and Maritime, which align with the strategic direction of the Group.

2019 Sales[1]



A	Electronic Systems	22%
B	Cyber & Intelligence	9%
C	Platforms & Services (US)	17%
D	Air	37%
E	Maritime	15%

2019 Underlying EBITA[2]



A	Electronic Systems	31%
B	Cyber & Intelligence	4%
C	Platforms & Services (US)	12%
D	Air	40%
E	Maritime	13%

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, precision guidance and seeker solutions, next-generation military communications systems and data links, persistent surveillance capabilities and hybrid electric drive systems.

Electronic Systems is well positioned to address current and evolving US defence priority programmes from its strong franchise positions in electronic warfare, precision guidance and seeker solutions. Electronic Systems has a long-standing programme of research and development. 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 ability to apply innovative technology solutions that meet defence customers' changing requirements. As a result, the business is well positioned for the medium term with strong significant roles on F-35 Lightning II, F-15 upgrade and classified programmes, as well as with specific products such as APKWS®. Over the longer term, the business is poised to leverage its technology strength in emerging areas of demand such as precision weaponry, space resilience, hyper-velocity and autonomous vehicles. In the commercial aviation market, Electronic Systems' technology innovations are enabling the business to maintain its long-standing customer positions and to compete for, and win, new business and with our electric hybrid propulsion capability we are well placed to continue to address the need for low and zero emission technology.

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 financial security activities.

Intelligence & Security

The outlook for the US government services sector is stable, although market conditions remain highly competitive and continue to evolve. The US business remains well positioned and will continue to leverage its established market positions and reputation for reliable and adaptable performance to meet customer demands for innovative, cost-effective and cyber-hardened solutions to pursue both recompeted contracts and new business across its portfolio of sustainment, integration and modernisation solutions for military and intelligence customers.

Applied Intelligence

The services and products we offer under our Government and Financial Services divisions are well placed to deliver growth and increased profitability, as cyber security becomes an increasingly important part of a nation's security and a core element of stewardship for companies in a sophisticated and persistent threat environment.

1. Revenue plus the Group's share of revenue of equity accounted investments.
2. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items.

06 Alternative performance measure definitions

20 Our markets

Platforms & Services (US), with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including naval ship repair, and the management and operation of government-owned munitions facilities.

Combat Vehicles is underpinned by a growing order backlog and incumbencies on key franchise programmes. These include the US Army's Armored Multi-Purpose Vehicle, M109A7 self-propelled howitzer, Bradley upgrade programmes, Amphibious Combat Vehicle, M88, as well as the CV90 and BvS10 export programmes from BAE Systems Hägglunds. FNSS continues to execute on its order book of both Turkish and international orders. These long-term contracts and franchise positions make the combat vehicles business well placed for growth in the medium term. The team is working on, and is closely following, the US Army's acquisition plans for its next generation of combat vehicles, in particular the mobile protected firepower and robotic combat vehicle programmes.

In the maritime domain, the sector has a strong position on naval gun programmes and US Navy ship repair activities where the business has invested in facilities in key homeports. This capitalised infrastructure represents a high barrier to entry, and the business remains well aligned to the US Navy's operational strategy. The Group remains a leading provider of gun systems and precision strike capabilities and, in the complex ordnance manufacturing business, continues to manage and operate the US Army's Radford and Holston munitions facilities under previously awarded contracts.

Air comprises the Group's UK-based air activities for European and International Markets, and US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture.

Future Typhoon production and support sales are underpinned by existing contracts. Discussions continue in relation to potential further contract awards for Typhoon which would extend current production revenues. Production of rear fuselage assemblies for the F-35 will increase in 2020 to reach its expected peak rate for the decade. The business plays a significant role in the F-35 sustainment programme, and revenues are set to grow as the number of aircraft deployed increases over the coming years. Defence and security remain priorities for the UK government. The UK Combat Air Strategy provides the base to enable long-term planning and investment in a key strategic part of the business.

In Saudi Arabia, the In-Kingdom Industrial Participation programme continues to make good progress consistent with our long-term strategy, as well as the Saudi Arabian government's National Transformation Plan and Vision 2030. In order to provide ongoing capability to international customers, the Group is reliant on the continued approval of export licences by a number of governments. The withholding of such export licences may have an adverse effect on the Group's provision of capability to the Kingdom of Saudi Arabia and the Group will seek to work closely with the UK government to manage the impact of any such occurrence.

The Australian business has long-term sustainment and upgrade activities in maritime, air, wide-area surveillance, missile defence and electronic systems. The Hunter Class frigate programme is expected to drive growth in the coming years.

MBDA has a strong order book which is driving increasing production and sales. Development programmes continue to improve the long-term capabilities of the business, and as European nations embark on new combat air systems development, MBDA will be well placed to provide the technologies and system solutions required to deliver efficient and competitive armaments to these platforms.

Maritime comprises the Group's UK-based maritime and land activities.

Overall the outlook is stable based on long-term contracted positions. Within Submarines, the business is executing the Astute Class programme, with four boats still in build. On the Dreadnought programme manufacturing activities continue on the first of class boat. Investment continues in the Barrow facilities in order to provide the capabilities to deliver these long-term programmes through the next decade and beyond. In shipbuilding, following the completion of the two aircraft carriers, sales are underpinned by the manufacture of Type 26 frigates. The through-life support of surface ship platforms provides a sustainable business in technical services and mid-life upgrades.

Land UK

Future work will be underpinned by existing support contracts and the expected workshare on the Mechanised Infantry Vehicle programme.

Munitions supply continues under the Munitions Acquisition Supply Solution partnering agreement secured in 2008.

How we manage risk

Effective management of risks 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 the Group 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:

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 2019 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 and Group functions 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 and Group functions. 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. These key risks are reported to the Board on a regular basis.

Principal and emerging risks

The Board has carried out a robust assessment of the emerging and principal risks facing the Group. Emerging and principal risks have been identified, and are managed or mitigated, through the application of the policies and processes outlined above.

Principal risks include those that would threaten the Group's business model, future performance, solvency, liquidity or reputation. Risks have been identified as principal based on the likelihood of occurrence, the potential impact on the Group and the timescale over which they might occur. The principal risks, together with details of how they are being mitigated and managed, are detailed on pages 78 to 81.

78 Our principal risks

Risk management framework

Board – Overall responsibility for risk management

Risk challenge, monitoring and reporting

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

Corporate Responsibility Committee
Non-financial Risk Register

Risk challenge, monitoring and reporting

Risk challenge, monitoring and reporting

Risk challenge, monitoring and reporting

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

Risk challenge, monitoring and reporting

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

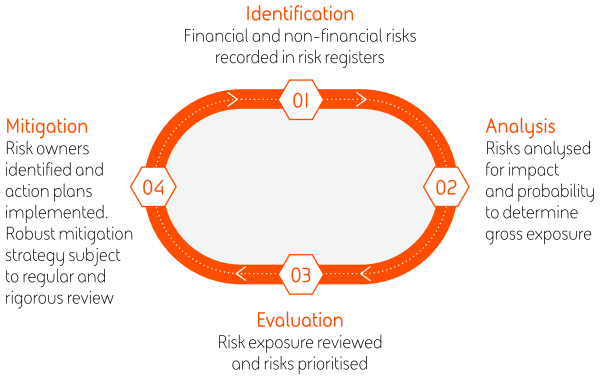
Quarterly Business Review – Core Business Process*
Quarterly management review of the performance of each of the Group's businesses against their objectives, measures and milestones

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

Strategic objectives and shareholder value

Business Risk

Risk Management Policy – Mandated Policy*

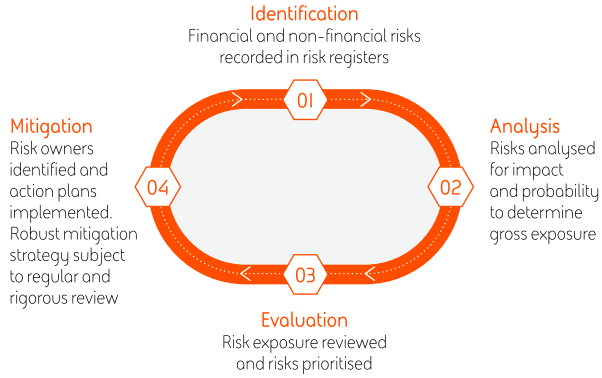


Operational Assurance Statement – Mandated Policy*
Six-monthly management self-assessment of compliance with the Operational Framework and summary of key risks

Project objectives and financial return

Project Risk

Lifecycle Management Framework – Mandated Policy*



Lifecycle Management Project Performance Review*
Regular management review of project performance and issues to ensure that appropriate decisions and actions are taken

Audit Review Board
Assurance of the Business and Project Risk management processes as mandated in the Audit Charter. Including Operational and Non-financial Risk Management assurance

*As defined in the Group's Operational Framework.

84 Operational Framework

Our 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.

Description	Impact	Mitigation
Defence spending The Group is dependent on defence spending.		
In 2019, 92% of the Group's sales were defence-related. Defence spending by governments can fluctuate depending on change of government policy, other 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 UK.	Lower defence spending by the Group's major customers could have a material adverse effect on the Group's future results and financial condition.	The business is geographically spread across US, UK and international defence markets: – in the US, in July 2019 a two-year budget agreement was signed to lift the deficit ceiling and budget caps. The fiscal year 2020 appropriations bill was passed in December, closing out the Continuing Resolution. The fiscal year 2020 measure and the currently established fiscal year 2021 defence spending cap continue to demonstrate strong bi-partisan support for defence, and maintains support for our medium-term planning assumptions and positive momentum for military readiness and modernisation programmes; – in the UK, defence and security remains a priority for the UK government. The UK government recently stated its commitment to uphold the NATO commitment to spend at least 2% of Gross Domestic Product on defence, and to increase the defence budget by at least 0.5% above inflation, in every year of the current Parliament. The government is also expected to launch an Integrated Foreign Policy, Defence and Security Review during the course of 2020; – in Saudi Arabia, regional tensions continue to dictate that defence remains a high priority; and – in Australia, regional instability and the rapid pace of military modernisation and technology advancement in the Asia-Pacific region continue to drive the government's commitment to defence spending, with major recapitalisation programmes underway in the air, maritime and land domains. The government has indicated its intent to grow defence spending by committing to spend 2% of GDP by 2020/21. 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 portfolio of commercial businesses, including commercial avionics.
Government customers The Group's largest customers are governments.		
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.	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.	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.

Description	Impact	Mitigation
International markets The Group operates in international markets.		
BAE Systems is an international company conducting business in a number of regions, including the US and the Middle East. The risks of operating in some countries include: social and political changes impacting the business environment; economic downturns, political instability and civil disturbances; the imposition of restraints on the movement of capital; the introduction of burdensome taxes or tariffs; change of export control and other government policy and regulations in the UK, US and all other relevant jurisdictions; and the inability to obtain or maintain the necessary export licences. In June 2019, the Court of Appeal of England and Wales directed the United Kingdom Secretary of State for International Trade to revisit the decision-making process for granting licences for the sale of military equipment to the Kingdom of Saudi Arabia for possible use in the conflict in Yemen and to retake its decisions regarding such licences on that basis. BAE Systems will assess the result of the retaking by the Secretary of State of such decisions, once they have been made. Pursuant to the Order of the Court, the Secretary of State undertook not to grant new licences for the export of arms or military equipment to Saudi Arabia for possible use in the conflict in Yemen until such decisions have been retaken. Both the Secretary of State and the other party to the proceedings have sought and obtained permission to appeal the Court's ruling to the Supreme Court.	The occurrence of any such events could have a material adverse effect on the Group's future results and financial condition. The risk of the Group's inability to obtain and maintain the necessary export licences for our business in Saudi Arabia could affect the Group's provision of capability to the country.	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 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. 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.
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 EU referendum in the UK.		The Group's policy is to hedge all material firm transactional currency exchange rate exposures.
The terms of the UK's relationship with the EU after the end of the transition phase on 31 December 2020 are currently uncertain, rendering it difficult for the Group to prepare in detail for the changes in the regulatory environment that are likely to apply beyond the transition phase. There is also a risk that, as a result of the UK leaving the EU, the Group's ability to take part in collaborative industrial programmes in Europe could encounter new EU barriers.	BAE Systems benefits from a large order backlog with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia and there is relatively limited UK-EU trading. In respect of people, the majority of persons employed in the UK are UK nationals, with only limited movement of EU nationals into and out of the Group's UK businesses. Accordingly, the resulting Brexit near-term impacts across the business are likely to be limited.	The UK's departure from the EU with a Withdrawal Agreement and entry into a transition phase has materially reduced the risk of an immediate change in trading arrangements with the EU. The planning that the Group undertook for a potential no-deal Brexit will help to inform our preparations for the possible range of outcomes following the end of the transition phase, including but not limited to customs procedures, export controls, and the use of speciality chemicals, which is currently authorised by an EU agency. Separately, BAE Systems will support the UK government in achieving its aim to ensure that the UK maintains its key role in European security and defence post-Brexit, and to strengthen bilateral relationships with key partners in Europe. This will be important for ongoing collaboration in the development of defence capabilities.
Competition in international markets The Group's business is subject to significant competition in international markets.		
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 is dependent upon US and UK government support in relation to a number of its business opportunities in export markets.	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 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.

Description	Impact	Mitigation
Laws and regulations The Group is subject to risk from a failure to comply with laws and regulations.		
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. 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.
Contract risk and execution The Group has many contracts, including a small number of large contracts and fixed-price contracts.		
In 2019, 46% of the Group's sales were generated by its 15 largest programmes. At 31 December 2019, the Group had seven 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 leadership development programme for project directors continues to be 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.
Contract awards and cash profiles The Group is dependent on the award timing and cash profile of its contracts.		
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.

Description	Impact	Mitigation
Pension funding The Group has an aggregate funding deficit in its defined benefit pension schemes.		
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 funding deficits may be adversely affected by changes in a number of factors, including investment returns and members' anticipated longevity.	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 October 2019 the assets and liabilities of six of the Group's pension schemes were consolidated into a single scheme. This was carried out to drive long-term efficiencies. Following the merger, the Company and Trustees agreed to carry out an early triennial funding valuation as at 31 October 2019. In February 2020 that valuation and deficit recovery plan were agreed with the Trustees after consultation with The Pensions Regulator in the UK. The funding deficit as at 31 October 2019 was £1.9bn. As part of the valuation agreement, the Company has agreed to pay £1bn into the Scheme in the coming months, representing an advancement of £1bn of deficit contributions due between 2022 and 2026. The next UK triennial funding valuations for the other smaller UK pension schemes will be carried out as at 31 March 2020. The latest update shows that these schemes remain in surplus.
Information technology security The Group could be negatively impacted by information technology security threats.		
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.
People The Group's strategy is dependent on its ability to recruit and retain people with appropriate talent and skills.		
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 the Group's 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.
Acquisitions The anticipated benefits of acquisitions may not be achieved.		
BAE Systems considers investment in value-enhancing acquisitions where market conditions are right and where they deliver on its strategy. Whether BAE Systems realises the anticipated benefits from these transactions depends upon the successful integration of the acquired businesses as well as their post-acquisition performance in the markets in which they operate.	The diversion of management attention to integration efforts and the performance of the acquired businesses below expectations could adversely affect BAE Systems' business and create the risk of impairments arising on goodwill and other intangible assets.	The Group has established policies in place to manage the acquisition process, monitor the integration and performance of acquired businesses, and identify potential impairments.

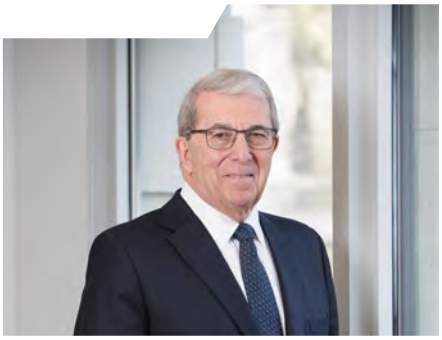
The risk entitled 'The anticipated benefits of acquisitions may not be achieved' is a new risk included in this year's report as a result of the proposed acquisitions by the Group for a total estimated $2.2bn of Collins Aerospace's Military Global Positioning System business and Raytheon's Airborne Tactical Radios business. 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 19 February 2020.

David Parkes
Company Secretary

Chairman's governance letter



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Dear Shareholders,

As outlined in my Opening Letter, the Board has consistently believed that being performance driven, but values led, captures the ethos and culture of our business.

During the course of the year there is no doubt that stakeholder interest in the environment, society and governance has moved up the corporate agenda. These topics now rightly sit alongside financial performance as important measures for assessing the quality of management, sustainability of the business model and commitment of the Company to the wider community.

In order to give an insight into our actions that seek to demonstrate our commitment to these important issues, the following is an outline of our Board leadership, stakeholder engagement, environmental management and community support.

An overview of our governance processes and procedures is given on pages 84 and 85, also on pages 28 to 33, where the Board has provided its report on how the Directors have discharged their duties under Section 172 of the Companies Act. The skills and composition of the Board are provided in detail in my report on the Nominations Committee on pages 99 to 101.

The Board, of course, is supplemented by Committees which provide a more granular engagement in all aspects of oversight and governance from Remuneration to Audit to Nominations and to Corporate Responsibility. The tone at the top sets the standards of good governance and behaviour that flow through the organisation. I am therefore confident that these Committees and the Board as a whole function effectively as guardians of good corporate discipline, rigour and behaviour.

Board leadership

The first principle in the UK Corporate Governance Code deals with a board leading a company, and, in doing so, promoting its long-term sustainable success for shareholders and also contributing to wider society. Good strategy and business planning underpin long-term success, and for two days last November the Board undertook a detailed review of these matters. We looked at the global defence, aerospace and security markets, and at the opportunities we have to grow the business. The Board also considered the need to invest in the future, recognising that well-focused investment is vital to the long-term success of the Company – whether that is in R&D, people and skills or acquiring complementary businesses. One of the priorities we confirmed during these discussions was the strategic priority of investing in the future of our US Electronic Systems business. These discussions meant that we were well placed to react when the opportunity arose shortly afterwards to acquire two high-quality complementary businesses that became available at short notice.

In addition to investing for the future, the long-term sustainable success of a company must be based on a well-developed understanding of the risks that could affect a business and the steps that can be taken to mitigate them. As part of last November's Strategy Review, the Board looked at the business plan for the next five years, and also considered the principal risks that could impact the Company during this period and the resources available to sustain the Company should one or more of these risks impact our business. This work was an essential part of the analysis behind the statement we make on page 89 regarding the prospects of the Company and its ability to meet its liabilities as they fall due over the five-year period of our business plan.

The less tangible matters of company culture and values are equally as important to the long-term sustainable success of the company. At the heart of our culture, our behaviours are essential in ensuring that our employees have the right approach when it comes to developing the business and delivering for our customers and other stakeholders. It is also fundamental to maintaining a reputation for high standards of conduct and thereby retaining the trust of our customers and wider society.

During the year, the Board discussed culture with the Chief Executive and he shared with directors the work being done to clearly define behaviours to ensure we focus on performance, not just in terms of what we do, but how we do it. The Board will continue to be vigilant in monitoring our culture, values and how these behaviours are embedded across the company. We will also look at the steps taken to ensure we continue to have meaningful engagement with our workforce.

To keep a check and balance on Board activity we conduct a thorough Board evaluation annually and secure the services of a professional external adviser every other year to ensure independence of mind and judgement. Confidential interviews are conducted with each Board member, and comments and views are consolidated into a formal report that is shared with the Board. Recommendations for change and improvement are given, adopted where appropriate, and implemented and monitored through the year.

The Board remains enthusiastic about the evaluation process and the value that it brings to improving performance. Following this year's evaluation we have agreed a number of objectives, including spending more time considering culture and purpose, doing more on stakeholder engagement and reviewing how we consider strategy beyond our normal five-year planning period. I have included more details of the evaluation in my Nominations Committee report on pages 99 to 101.

Shareholders

We have a professional and well-respected Investor Relations team who provide day-to-day contact with investors. Senior executives, including the Chief Executive, Group Finance Director and the Chief Executive Officer of our US business, supplement this relationship with regular meetings in the year. As Chairman, I visit many of our major shareholders in the course of the year as does the Chair of our Remuneration Committee.

In concert with our one-to-one visits, we also hold an annual shareholder forum specifically focused on non-financial matters, in order that shareholders can interrogate non-executives on culture, governance, committee work and environmental management.

The AGM also provides a forum for robust debate on the purpose and performance of our company.

I believe the combination of all these interactions gives a valuable, transparent insight into what we do, how we do it and the requirements that shareholders may have as to how we can and should do it more effectively.

Employees
We also considered wider stakeholder engagement during the year, and engagement with employees in particular. In 2018, the Board considered the new provision in the Code requiring boards to establish a mechanism through which they can engage with their workforce. We agreed that this responsibility should rest with our Corporate Responsibility Committee. On pages 95 to 98 the Chairman of that Committee, Ian Tyler, has reported on how this responsibility was discharged during the year. One example of which was him joining our Chief Executive in meeting with our principal UK trade unions at half-yearly intervals for an open, constructive and transparent discussion about the business in general and any matters of specific interest to employees. These discussions have consistently proved to be a strong and effective communication channel with all parties benefiting from the dialogue.

Throughout the year visits are made by myself as Chairman and other non-executive members of the Board, both as a group and as individuals, looking to develop their understanding of the Company. In 2019, the Board visited our US Electronic Systems business in Endicott and the Submarines business in Barrow-in-Furness. Town Hall meetings conducted during these visits showed a positive level of engagement and a willingness to ask challenging questions in the spirit of constructive interest. These visits highlighted the duties we have reported on in our Section 172 report (see pages 28 to 33). They emphasised the importance of investing for the long-term in people, technology and facilities, and how this supports a range of stakeholders. In Barrow we met with apprentices at the start of their careers and heard how they are benefiting from our investment in skills and training, and in Endicott we met with employees whose technical know-how and innovation are essential to the future of the business. Through such visits we also develop our customer knowledge further and appreciate our commitments to them and the end-users of our products. We are also able to witness at first-hand the mutually beneficial relationship we have with local communities and wider society.

In addition to visits, regular podcasts are produced with the Chief Executive and Group Finance Director, along with many other forms of communication, including the launch of an employee app, to ensure that everyone is kept up-to-date on our progress and performance.

Acknowledging a job well done is a feature of employee engagement. The Chairman's Gold Awards recognise outstanding achievements at all levels in the Group with awards given at executive level and an annual Gold Award ceremony for the outright worldwide winners. This award is enthusiastically supported and encourages stretch performance, strong corporate engagement and celebrates remarkable endeavour. It is an important and valued event in the corporate calendar with award certificates proudly displayed in our business locations throughout the world.

Customers
Building and managing close, transparent and mutually beneficial working relationships is at the heart of our business model requiring regular contact with government, senior officials, the military and commercial executives across the globe. In addition to day-to-day involvement with myself, the Chief Executive and other members of the executive team, Board members are encouraged to attend armed forces' celebratory events, BAE Systems corporate customer evenings and conduct open conversation with senior military leaders as guests at a Board dinner.

I believe this mix of formal and informal dialogue continues to provide a valuable exchange of views and a deeper sense of engagement with our customers across the world.

Suppliers
The senior leadership team in our supply chain management have made material progress in building and strengthening a professional and commercially beneficial relationship with our suppliers over the course of a number of years.

We regard our supply chain as partners and believe that sharing knowledge and views on best practice will improve productivity and quality for the benefit of all. As a leading member of 'Be the Business', an independent body of like-minded major UK companies, we have constructed a productivity improvement programme involving formal training at Lancaster University and insights into BAE Systems' methods and technology for our SME suppliers through open house site visits.

This has proved to be a considerable success for all parties.

Community
As a Company we have a deep commitment to supporting the community in which we work and the needs of the military personnel we serve.

This commitment is reflected through the engagement of employees in local charities; the donations we make to worthy and relevant causes, and the flagship investments we make in projects like the Defence and National Rehabilitation Centre in Nottinghamshire where our support is reflected and acknowledged in The BAE Systems Performance Maximization Centre.

As Chairman, I have the privilege to be Vice-President of the Royal Navy and Royal Marines Charity. The RAF Benevolent Fund also receives our sponsorship at the Royal International Air Tattoo at RAF Fairford each year.

By making contributions large and small, we seek to ensure that we continue to remember to serve those that protect and serve us.

The environment
The scale of global climate change is becoming increasingly evident and the importance of caring for our environment and mitigating natural disasters becomes an essential rather than optional business priority. To that end, over the last five years, we have reduced total carbon emissions by 15%. This is a result of various factors, including site and operational improvements. However, we know we must continue to reduce carbon and we are investing in technologies and setting targets to help achieve this.

The majority of our greenhouse gas emissions come from the energy we use across our facilities. Therefore, our focus is on making our facilities more efficient and using electricity from lower-emission sources. To date, we have set energy targets at business level but in 2020 we will also establish a global target for the Company.

The Task Force on Climate-related Financial Disclosures (TCFD) was set up to develop recommendations to help companies and other organisations disclose clear, comparable and consistent information about the risks and opportunities presented by climate change. We are supportive of the move to improve the coherence and consistency of disclosures in this area, and are working towards reporting our commitments on climate-related matters in line with the TCFD recommendations by 2022.

The Board and Corporate Responsibility Committee will continue to oversee activity in this area and ensure that we are robust in our approach to reducing carbon emissions and other environmental impacts.



Sir Roger Carr
Chairman

Board governance

This is the structure through which we manage the Company. It has evolved over time, and continues to evolve to meet the needs of the business and our stakeholder responsibilities.

Shareholders

The Company has approximately 100,000 individual, corporate and employee shareholders.

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 auditor.

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

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

The non-executive directors provide constructive challenge, strategic guidance, offer specialist advice and hold management to account. In addition, they set the remuneration of the executive directors and oversee Board succession planning.

Chairman

Leads the Board and is responsible for its overall effectiveness in directing the Company. Also facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.

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

Supports the Board by ensuring that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.

Oversight of performance and compliance with Operational Governance

The Operational Framework 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. It is reviewed and approved annually by the Board.



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.

91 Audit Committee

95 Corporate Responsibility Committee

99 Nominations Committee

102 Remuneration Committee

Operational governance

How we work

The Operational Framework sets 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 18). 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.

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 the Code's 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
Lays out the standards that are expected of each of us, to support us in doing the right thing. All employees receive annual training designed to stimulate conversations about ethical decision-making.

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
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.

Risk framework
This is how we identify, analyse, evaluate and mitigate risk (see page 77).

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.

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. The Internal Audit Director reports functionally to the Audit Committee and, for day-to-day operations, to the Chief Executive.

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)
Creates an agreed five-year business plan and robust strategy against which performance is monitored through our Performance Management Process.

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.

Leadership Framework
Supports the development of a diverse and inclusive culture that delivers the Company strategy. Provides a principled approach to employee performance, assessment, development and reward.

18 Group strategic framework

Board of directors



A **Sir Roger Carr**
Chairman



B **Charles Woodburn**
Chief Executive



C **Peter Lynas**
Group Finance Director



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



E **Revathi Advaithi**
Non-executive director



F **Dame Elizabeth Corley CBE**
Non-executive director



G **Chris Grigg**
Non-executive director



H **Stephen Pearce**
Non-executive director



I **Nicole Piasecki**
Non-executive director



J **Paula Rosput Reynolds**
Non-executive director



K **Nick Rose** Non-executive director and Senior Independent Director



L **Ian Tyler**
Non-executive director

A 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. 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.

Sir Roger is a Senior Advisor to KKR and Chairman of the English National Ballet. In 2018, he was appointed as co-chair of the Industrial Infrastructure and Manufacturing Council, an advisory council to the Prime Minister. He was also appointed as Vice President of the Royal Navy and Royal Marines Charity in September 2018.

He has previously held a number of senior appointments including Chairman of Centrica plc, Vice Chairman of the BBC Trust, Deputy Chairman and Senior Independent Director of the Court of the Bank of England, President of the Confederation of British Industry, Chairman of Cadbury plc, Chairman of Chubb plc, Chairman of Mitchells & Butlers plc, Chairman of Thames Water plc and Chief Executive of Williams plc.

Throughout his career he has served on a number of external committees including the Prime Minister's Business Advisory Group, the Manufacturing Council of the CBI, The Higgs Committee on Corporate Governance and Business for New Europe. He is a Fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, a Companion of the Institute of Management, and an Honorary Fellow of the Chartered Governance Institute. He is also a Visiting Fellow of Saïd Business School, University of Oxford and holds an Honorary Doctorate in Business from Nottingham Trent University.

He was knighted for Services to Business in the Queen's New Year's Honours list 2011.

Other non-executive appointments

None.

Committee membership

Chairman of the Nominations Committee.

B Charles Woodburn Chief Executive

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

Skills, competence and experience

Charles joined BAE Systems in May 2016 as Chief Operating Officer and became Chief Executive on 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.

Non-executive appointments

None.

C 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. His role has since been expanded to include responsibility for UK Shared Services, Procurement and Group Mergers & Acquisitions.

Peter 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.

The Company has announced that Mr Lynas will retire from the Board on 31 March 2020.

Non-executive appointments

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

Chairman
Executive directors
Non-executive directors

D Jerry DeMuro 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. Prior to joining the Company, 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.

Jerry has been actively involved with several associations and non-profit organisations, including the Aerospace Industries Association, where he is currently a member of its Executive Committee, the Association of the United States Army, the MILCOM Conference Board, and AFCEA International, where he served on the Board of Directors as an Executive Committee member and as chair of the Audit Committee.

The Company has announced that Mr DeMuro will step down from the Board on 31 March 2020.

Non-executive appointments

None.

E Revathi Advaithi Non-executive director

Appointed to the Board: 2018 **Nationality:** US

Skills, competence and experience

Revathi has extensive operational experience and a deep understanding of digital technology and international markets, gained from her leadership of multinational engineering and manufacturing businesses. In February 2019, Revathi assumed the role of Chief Executive Officer and became a member of the board of directors at Flex Ltd, a global manufacturing company. Prior to this appointment, Revathi was president and chief operating officer for the Electrical Sector business at Eaton, a power management company. She joined Eaton in 1995 and led the Electrical Sector in the Americas and Asia-Pacific, with a three-year assignment in Shanghai. Between 2002 and 2008, Revathi worked at Honeywell, where she held leadership roles spanning manufacturing, procurement, supply chain and sourcing, including a role as general manager, Automation and Control Solutions. Revathi returned to Eaton in 2008 as vice president and general manager of the Electrical Components division.

Other non-executive appointments

None.

Committee membership

Corporate Responsibility Committee and Nominations Committee.

F Dame Elizabeth Corley CBE Non-executive director

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

Skills, competence and experience

Dame Elizabeth brings investor, governance and boardroom experience to the Board. She currently chairs the board of the Impact Investment Institute, having previously chaired the industry Taskforce on Social Impact Investing for the UK government. She has 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. Dame Elizabeth is active in representing the investment industry and developing standards within it. She is a member of the CFA Future of Finance Advisory Council and the AQR Institute of Asset Management at the London Business School. In 2017, she stepped down from the board of the UK Financial Reporting Council after completing her second three-year term of appointment.

Dame Elizabeth is also an acclaimed writer, a Fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce and a trustee of the British Museum.

Other non-executive appointments

Non-executive director of Pearson plc and Morgan Stanley.

Committee membership

Nominations Committee and Remuneration Committee.

G 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. Chris is currently a member of the executive board of the European Public Real Estate Association and the board of the British Property Federation.

Other non-executive appointments

None.

Committee membership

Corporate Responsibility Committee, Remuneration Committee and Nominations Committee.

H Stephen Pearce Non-executive director

Appointed to the Board: 2019 **Nationality:** AU

Skills, competence and experience

Appointed to the Board on 1 June 2019, Stephen has more than 16 years of public company director experience and over 30 years of financial and commercial experience in the mining, oil and gas, and utilities industries. Stephen is currently Finance Director of Anglo American plc, a role he has held since April 2017, and a director of its South African listed majority-owned subsidiary, Anglo American Platinum Ltd. He previously served as CFO and an executive director of Fortescue Metals Group Limited from 2010 to 2016. He is a Fellow of the Institute of Chartered Accountants, a Member of the Governance Institute of Australia and a member of the Australian Institute of Company Directors.

Other non-executive appointments

None.

Committee membership

Chairman of the Audit Committee and member of the Nominations Committee.

I Nicole Piasecki Non-executive director

Appointed to the Board: 2019 **Nationality:** US

Skills, competence and experience

Nicole was appointed to the board on 1 June 2019 and brings extensive experience gained from executive positions within the aerospace industry and leadership of multi-functional teams. She previously held a number of engineering, sales, marketing and business strategy roles during her 25-year career with the Boeing Company, including Vice President and General Manager of the Propulsion Systems Division and Vice President of Business Development & Strategic Integration for Boeing's commercial aircraft business, and President of Boeing Japan. She is Chair of the Board of Trustees of Seattle University. Nicole formerly served on the Federal Aviation Authority's Management Advisory Board, the US Department of Transportation's Future of Aviation Advisory Committee and the Federal Reserve Bank of San Francisco's Seattle branch.

Other non-executive appointments

Weyerhaeuser Company.

Committee membership

Nominations Committee.

J 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.

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.

Past roles include non-executive directorships at Coca-Cola Enterprises Inc., Anadarko Petroleum Corporation, Delta Air Lines Inc., Air Products and Chemicals Inc., Siluria Technologies, Inc., TransCanada Corporation and CBRE Group, Inc.

Other non-executive appointments

Non-executive director of BP p.l.c. and General Electric Company.

Committee membership

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

K Nick Rose Non-executive director and Senior Independent Director

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

Skills, competence and experience

Nick has considerable financial expertise and boardroom experience and was formerly 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 and former non-executive director of Moët Hennessy SNC and Scottish Power plc.

Nick is currently an adviser to CCMP Capital Advisors, LLC.

Mr Rose will step down from the Board on 31 March 2020.

Other non-executive appointments

Chairman of Williams Grand Prix Holdings PLC; non-executive director and senior independent director of BT Group plc; and non-executive chairman of Loch Lomond Group.

Committee membership

Member of the Nominations Committee and Remuneration Committee.

L 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. 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 as Chief Executive in 2005. He is currently Chairman of Bovis Homes Group PLC and Cairn Energy PLC.

Ian is a former non-executive director of Mediclinic International plc, Cable & Wireless Communications Plc and VT Group plc.

Other non-executive appointments

Chairman of Amey plc, a subsidiary of Ferrovial, S.A., and AWE Management Limited.

Committee membership

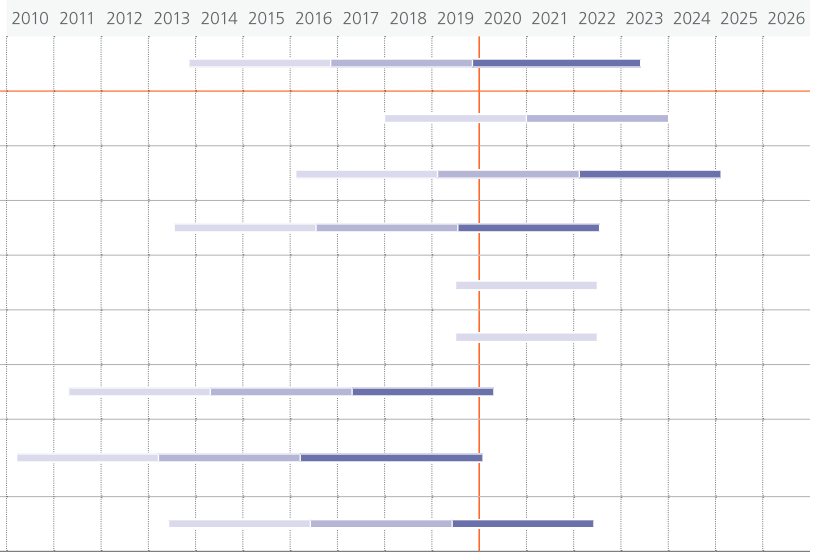
Chairman of the Corporate Responsibility Committee, and member of the Audit Committee, Remuneration Committee and Nominations Committee.

Board information

- Chairman
- Non-executive director
- Executive director
- Committee chair
- A Audit Committee
- N Nominations Committee
- C Corporate Responsibility Committee
- R Remuneration Committee
- First term
- Second term
- Third term

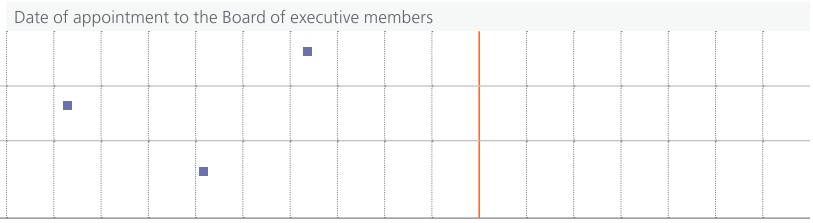
Membership

	Committee membership	Nationality
Sir Roger Carr Chairman[1]	N	UK
Revathi Advaithi Non-executive director	C N	US
Dame Elizabeth Corley Non-executive director	N R	UK
Chris Grigg Non-executive director	C N R	UK
Stephen Pearce Non-executive director	A N	AU
Nicole Piasecki Non-executive director	N	US
Paula Rosput Reynolds Non-executive director	N R	US
Nick Rose Non-executive director and Senior Independent Director	N R	UK
Ian Tyler Non-executive director	A C N R	UK



The average length of appointment of non-executive members of the Board (as at 31 December 2019) was five years.

	Nationality
Charles Woodburn Chief Executive	UK
Peter Lynas Group Finance Director	UK
Jerry DeMuro President and Chief Executive Officer of BAE Systems, Inc.	US



The average length of appointment of executive members of the Board (as at 31 December 2019) was 6.1 years.

1. Sir Roger Carr joined the Board in October 2013 and was appointed as Chairman in February 2014.

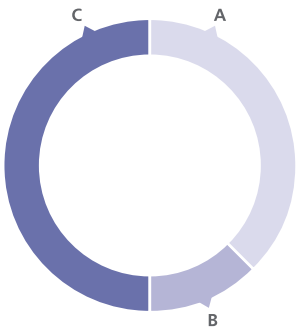
Attendance

Individual directors' attendance at meetings of the Board and its committees in 2019

	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Revathi Advaithi	8/8	–	4/4	4/5	–
Sir Roger Carr	8/8	–	–	5/5	–
Dame Elizabeth Corley	8/8	–	–	5/5	7/7
Jerry DeMuro	8/8	–	–	–	–
Harriet Green[1]	4/7	–	0/3	3/4	–
Chris Grigg	8/8	–	4/4	5/5	–
Peter Lynas	8/8	–	–	–	–
Stephen Pearce[2]	5/5	–	–	1/1	–
Nicole Piasecki[2]	5/5	–	–	1/1	–
Paula Rosput Reynolds	8/8	5/5	–	5/5	7/7
Nick Rose	8/8	5/5	–	5/5	7/7
Ian Tyler	8/8	5/5	4/4	5/5	–
Charles Woodburn	8/8	–	–	–	–

1. Retired in November 2019. Attendance affected by personal matters. 2. Appointed in June 2019.

Tenure – independent non-executive directors



A	Up to three years	3
B	Over three and up to six years	1
C	Over six years	4

Board diversity



Governance disclosures

UK Corporate Governance Code (the Code) compliance

The Company was compliant with the provisions of the Code throughout 2019 with the exception of Provision 38 concerning pension contribution rates for executive directors (see below), and the Board has applied its principles in its governance structure and operations. The following statements are made in compliance with the Code.

Code compliance

Provision 38 of the Code states: "The pension contribution rates of executive directors, or payments in lieu, should be aligned with those available to the workforce". Recognising the practical issues involved and the Company's existing contractual commitment with regards to executive director pension provision, the Remuneration Committee has agreed an approach to this matter, which in summary is as follows:

- Charles Woodburn, Chief Executive, currently has an employer pension contribution rate of 19% of base salary, which was agreed when he joined the Company in 2016. The weighted average of such rates for active members across all UK pension schemes is 17%. With effect from the beginning of 2020, his employer pension contribution has been fixed at its current monetary value. Consequently, it is anticipated that over time his contribution rate will reduce to the rate of 17%;
- Peter Lynas, Group Finance Director, will retire at the end of March 2020. His successor, Brad Greve, who joined the Company in September 2019, will have an employer contribution rate of 8%, that being in line with the wider UK workforce participating in the Company's defined contribution arrangements. The same will apply in future for any new UK executive directors; and
- Jerry DeMuro, Chief Executive Officer of BAE Systems Inc., participates in a defined contribution retirement plan, for which the Company matches his contribution rate up to a maximum of 6%. The same provisions and features of the plan apply to the majority of participating active employees in the US plan, and will apply to Tom Arseneault when he succeeds Mr DeMuro on 1 April 2020.

For more details see Directors' remuneration policy on page 138 of this report.

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 76 and 77. These processes are an integral part of our governance framework, the Operational Framework, details of which can be found on page 84. 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 considered both the Company's long-term prospects and also its ability to continue in operation and meet its liabilities as they fall due over its five-year business planning period.

Analysis of business prospects

The Board has considered the long-term prospects of the Company based on our strategy, markets and business plan as outlined on pages 18 to 43 of this report. In its strategic review of the Company, the Board recognised the importance of certain factors that underpin its long-term prospects and viability. In summary, these are:

- a diverse portfolio of businesses based on well-established market positions, providing both complex, high technology products and programmes, and differentiated technical services and support. In 2019, 34% of group sales were product/programme related and 66% services and support;
- a geographically diverse business with a high proportion of sales to governments and other major prime defence contractors. In 2019, 36% of revenue was from the US Department of Defense, 21% from the UK Ministry of Defence and 14% from the Kingdom of Saudi Arabia Ministry of Defence and Aviation. Major new business wins in the Middle East, Australia and Canada provide a strong foundation for further market diversity and growth;
- long-term visibility of sales and future sale prospects through a substantial order backlog and incumbent positions on major defence programmes; and
- market positions underpinned by a highly skilled workforce, intellectual property assets and proprietary know-how, which are safeguarded and developed for the future by customer and Company funded investment. Such investment is focused on a well-developed understanding of future technologies and the threat environment shaping the long-term defence and aerospace market.

Assessment
The Board's assessment of the Company's prospects 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 emerging and 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 following:

- the Company being unable to access debt markets to renew term debt facilities;
- an unfavourable change to the terms of trade the Company enjoys with certain principal customers;
- the Company failing to win certain major export contracts; and
- the loss of a major export market.

The scenarios tested included the impact of multiple adverse factors.

Conclusion
In undertaking its review of the IBP in 2019, 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, 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 78 to 81).

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.

Prior to making new non-executive appointments, the Board considers other demands on an individual's time to ensure that, following appointment, directors have sufficient time to meet their board responsibilities. Non-executive directors are required to seek prior approval before taking on additional external appointments.

In addition to being a non-executive director of the Company, Ian Tyler is chairman of two FTSE 250 companies, Bovis Homes Group and Cairn Energy, and also two non-listed companies, AWE Management, a private company owned by three joint venture partners, and Amey, a subsidiary of Ferrovial, S.A., a Spanish listed company. The Chairman has reviewed Ian's other commitments and is satisfied that he has sufficient time to meet his responsibilities to BAE Systems. He will keep this matter under review.

Dame Elizabeth Corley, a non-executive director, is a non-executive director of Morgan Stanley, a US listed company. One of its UK subsidiaries provides broking services to the Company. Consequently, an assessment was undertaken to determine whether this relationship has a bearing on her independence for the purpose of Provision 10 of the Code. After review, it was determined that this was not a material business relationship given the relatively low value of the contractual arrangements and the nature of the relationship, i.e. broking services are provided by a UK subsidiary of Morgan Stanley, and her appointment is to the board of the US parent company and non-executive in nature. Should there be any material change in either her role with Morgan Stanley or the services its UK subsidiary provides to the Company, this decision will be reconsidered.

Nick Rose will retire from the Board at the end of March 2020, having served as a non-executive director for just over ten years. As detailed in the Company's 2018 Annual Report, recognising the change in Auditors and the level of geopolitical uncertainty last year, the Board considered that it was in the Company's and shareholders' best interests that his tenure as Senior Independent Director and Chairman of the Audit Committee be extended beyond the nine-year period detailed in Provision 10 of the Code. Stephen Pearce succeeded Nick Rose as Chairman of the Audit Committee at the start of the year, and Chris Grigg will succeed him as Senior Independent Director with effect from 1 April 2020.

Paula Rosput Reynolds will have served on the Board for nine years in April. She currently serves as a highly-valued Chair of the Remuneration Committee and is an important contributor to the Board, with a wealth of corporate knowledge and experience. The Board has agreed that Paula's term of office should be extended to April 2021. It further agreed that Ian Tyler should join the Remuneration Committee from the start of this year in preparation for him succeeding her as Chair of the Committee in 2021. The Board recognises the requirements with regards to non-executive directors serving for terms in excess of nine years and the possibility that this could impair, or appear to impair, a non-executive's independence. The Board has considered this, and believes that extending her term of office for an additional 12 months would not impact her independence, and retaining her services for this period will not only help provide for a well-managed handover of her Remuneration Committee responsibility, but also retain her knowledge and experience on the Board at a time of significant changes to its membership.

The Board considers all of the non-executive directors shown on pages 86 and 87 of this report to be independent in accordance with Code provisions.

Audit Committee report



Stephen Pearce
Chairman of the Audit Committee

Members

Stephen Pearce (Chairman)

Dame Elizabeth Corley

Ian Tyler

Dear Shareholders,

I am pleased to present the Audit Committee's report for the financial year ended 31 December 2019, having recently succeeded Nick Rose as Chairman of the Committee. To assist in transition of the chairmanship I have been in attendance at Committee meetings since mid-2019 when I joined the Board. In my role as Finance Director of another FTSE 100 company, it has been interesting to see the commonality of accounting, financial and risk-based issues across the two different sectors, as well as those that are specific to the Company and the environment in which it operates. I would like to acknowledge the work done by the Committee during the year and by the previous Chairman, Nick Rose, over the last eight years.

Paula Rosput Reynolds, who also provided valued input to the Committee over a number of years, stepped down from the Committee at the year-end with Dame Elizabeth Corley having been appointed in her stead.

Deloitte LLP have now completed their second full annual cycle as auditors having been appointed by the shareholders in May 2018. We have been pleased with the rigour and challenge that they have brought to bear which has given both the Committee and management the opportunity to consider how processes can be enhanced. Areas for review that were highlighted by Deloitte in their initial review of the Group's controls have been actioned. Whilst none of them were material, we have seen the benefit from their fresh perspective.

The section on the Audit Committee's year on page 94 provides an overview of the work that we have undertaken in the last 12 months and I will comment here on several aspects of that activity.

How the independence and effectiveness of the external audit process was assessed

Who we surveyed:

- Senior executives, including key finance roles
- Internal Audit Director

Areas we covered:

- Commitment to audit quality
- Technical knowledge
- Professional scepticism and robustness of challenge
- Understanding of industry and business risk
- Understanding of our internal control systems
- Quality of communications
- Level and quality of resourcing
- Commitment to improved standards

as well as interaction with the Committee members.

The output from the review was positive and demonstrated that the external auditor had continued to build on its understanding of the Group's business and key risks, and in providing robust and constructive challenge. Areas for focus in 2020 will include maintaining the continuity of audit teams and knowledge transfer, and enhancing communications in specific businesses.

On the basis of the review following the 2019 year-end audit, the Committee has proposed to the Board that it recommend that shareholders support the re-appointment of Deloitte LLP at the 2020 AGM.

External audit

In June we agreed the scope and level of materiality of the 2019 audit plan of work and discussed with Deloitte the areas that they had identified as key risks and other particular areas of focus, and the specific audit procedures that they would perform to undertake the related audit work. The benefit of having completed the first year's audit allowed for some recalibration of the work distribution across the full-year audit timeline.

Audit independence

We have reviewed in detail the confirmation and information received from Deloitte on the arrangements that they have in place to safeguard auditor independence and objectivity, which are consistent with the ethical standards published by the Financial Reporting Council (FRC), 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 auditor to provide non-audit services which we review on an annual basis. The policy prohibits certain activities from being undertaken by the auditor and also places restrictions on the employment of former employees of the auditor.

The policy permits the provision of Audit-Related Services and Permitted Non-Audit Services up to limits that are pre-approved by the Committee, with specific approvals required beyond such limits by the Committee. A copy of the policy is available on the Company's website.

We acknowledge the new UK Ethical Standard coming into force this year, and changes to policy are in the process of being made to reflect the new requirements.

Details of fees payable to the auditor are set out on page 170. In 2019, non-audit fees for Deloitte represented 11% of the audit fee. The principal non-audit services provided by Deloitte related to their review of the Half-yearly report and a US pension benefits audit.

Audit independence and effectiveness

We have taken the opportunity to refresh the methodology through which we assess audit independence and effectiveness, and the scope and output of our review of the effectiveness of the 2019 audit is set out below.

Audit Quality Review (AQR)

The FRC's AQR team monitors the quality of audit work of certain UK audit firms through inspections of a sample of audits and related procedures at individual audit firms. Deloitte have taken us through the findings from their latest AQR report and outlined initiatives being taken in respect of quality and quality control procedures.

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, controls reports, and reports from both internal and external auditors.

We have discussed the outputs of financial, IT and Lifecycle Management (LCM) controls testing, and any required improvement actions, with management, and internal and external audit, with a view to ensuring the ongoing robustness of the financial and operational environment, programme execution and risk mitigation. Areas of specific focus have included the following:

- LCM – 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 tend to be areas where judgement is required to be exercised. At the current time, when the Group has several large programmes in relatively early stages, adherence to LCM methodology is vital to ensure timely delivery, at target or better margins.
- Review of internal control environment in major export market – the Group's business in Saudi Arabia is undergoing a period of transformational change in support of the delivery of Saudi Arabia's Vision 2030 strategy to promote in-Kingdom industrialisation. During this transitional period, we took the opportunity to undertake a deeper dive into the controls environment and governance in both our wholly-owned business together with the Group's other shareholdings in the Kingdom of Saudi Arabia during 2019. This included discussion with senior executives of these businesses.
- Cyber risk – continues to be high on the agenda of many corporates. We met with the Chief Information Officer who presented a session on IT security and governance. The Group's IT assurance and governance programme continues to be enhanced with further input and support from the Internal Audit function.
- Export controls compliance – the Group General Counsel has kept us up-to-date during the year with ongoing developments in the export control compliance programmes and enhancements to existing procedures.

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 78 to 81.

Internal Audit
Internal Audit plays an integral role in the Company's governance structure and provides regular reports to the Committee. These include an overview of the work undertaken in the period under review, individual reports on audits conducted and progress against the agreed internal audit plan, as well as the outputs of the twice-yearly OAS process and the tracking of remedial action in the case of any control failures. Specific attention has been paid during the year to programme execution, given the volume of new programmes, and to IT assurance.

In order to allow the Internal Audit team and the wider business to view the internal audit programme in a more holistic way, a rolling three-year flexible programme has been developed and mapped against the Group's strategic priorities and risks, and those of the businesses. The aim is to enable Internal Audit to take a greater thematic approach to audits at Group level, whilst retaining flexibility aligned to business dynamics and emerging risk.

The first year of the three-year programme is prepared by Internal Audit on a risk-based basis. It 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 comprises a broad range of audits covering areas such as mandated governance, OAS outputs, risk register findings, change programmes, structural and business changes, and areas relating to responsible behaviour and non-financial risk. Internal Audit may also from time-to-time undertake other work within the context of the risk environment.

We have met with the VP, Internal Audit, to discuss the scope, environment and priorities for internal audit work undertaken within the US businesses and the levels of resourcing available to undertake the programme of work. We have also taken a closer look at the internal control environment around the US Combat Vehicles business.

During the year under review, and separate from the normal regular sessions we hold with the Internal Audit Director without management present, the Committee held a separate session with him, his heads of internal audit and the external auditor. The wide-ranging discussion at this year's session focused on forward-looking assurance and the identification of future risks, improving general controls and the application of LCM, the quality of reporting, resource for internal auditing, and the use of automation and analytics. It also enabled our external audit engagement partner to share his perspective on how he sees the audit scope and approach evolving during the next few years of Deloitte's audit tenure, and the future direction of financial assurance.

How the Committee assesses the independence and effectiveness of Internal Audit

Who we survey:
- Group-wide heads of Audit Review Boards
- Other business leaders

Areas for feedback include:
- Role of Internal Audit and independence
- Audit planning, processes and execution
- People resources and skilling
- Communications and reporting

Internal Audit is running a programme of continuous improvement relating to its purpose, people and process. The programme is informed by the results of the 2018 External Quality Assessment (EQA) undertaken by Ernst & Young LLP (EY) and also by the subsequent internal annual performance evaluation undertaken in 2019. Results from the 2019 annual evaluation were positive, with all respondents believing that Internal Audit played an integral role in assuring the governance of the Group. Areas for further development include enhanced emphasis on risk-related issues and the sharing of best practice identified during audit work at audit review boards.

Progress has been made against the 2018 EQA recommendations. Notable successes include upgrading and progressing with the deployment of the Export Controls assurance framework and improvements made to the Financial and IT control frameworks. Recruitment has been targeted to ensure that the Internal Audit function has the right skills, capabilities and capacity to deliver the audit programme, with guest auditors used as subject matter experts as required. Data Analytics were piloted in support of financial controls framework assurance in 2019 and a plan is in place to further develop analytics capability during 2020. A formal review of progress is planned with EY later this year. The recently published Internal Audit Code of Practice will inform future developments in Internal Audit.

Financial statements

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2019 financial statements, in addition to the going concern and viability statement reviews referred to below, were:

Recognition of revenue, profit and provisioning

The estimation of contract margin and the level of revenue and profit to recognise in a single accounting period require the exercise of management judgement.

The Committee reviewed key estimates and judgements applied in determining the financial status of the more significant programmes including:

- Type 26 frigate;
- Astute submarine;
- Saudi British Defence Co-operation Programme;
- Saudi Salam Typhoon; and
- US Land programmes.

Leases

From 1 January 2019 the Group adopted IFRS 16 Leases.

The Committee reviewed the Group's implementation and processes for the adoption of IFRS 16, and subsequently reviewed the actual impact, which was in line with the estimates provided in the 2018 Annual Report. We also considered the adequacy of the disclosures (see note 36 to the Group accounts on pages 224 and 225).

Pensions

Accounting for pensions and other post-employment benefits involves making estimates when measuring the Group's retirement benefit obligations. These estimates require assumptions to be made about uncertain events, such as discount rates, inflation rates and longevity.

Recognising the scale of the Group's pension obligation, we reviewed the key assumptions supporting the valuation of the post-employment 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 post-employment 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 note 23 to the Group accounts on pages 200 to 210).

Following consolidation of six of the Group's nine UK pension schemes into a single scheme in September 2019, and after consultation with the UK Pensions Regulator, the Group has reached agreement with the Trustee Board of the combined scheme on the accelerated funding valuation and revised deficit recovery plan. At the 31 October 2019 funding valuation date, the deficit was £1.9bn. The current deficit recovery plan which runs to 2026 will be replaced by a new deficit recovery plan, under which a one-off payment of £1bn is to be made in the coming months, with approximately £240m of funding payable in the scheme year ending 31 March 2020 and approximately £250m by 31 March 2021.

Goodwill

Impairment testing of goodwill on the balance sheet is underpinned by the value of the future prospects of the related business, which have to be estimated.

We considered the level of goodwill held on the Group's balance sheet and whether, given the future prospects of the acquired 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 177. No goodwill impairments were identified as a result of this review.

Taxation

Computation of the Group's tax expense and liability, the provisioning for potential tax liabilities and the level of deferred tax asset recognition are underpinned by management judgement and estimation of the amounts that could be payable.

Whilst tax policy is ultimately a matter for the Board's determination, we reviewed the Group's tax strategy as set out on page 51. Twice during the year, we reviewed the Group's tax charge and tax provisions, and discussed these with the Group Tax Director. We also reviewed the basis of recoverability of the deferred tax asset relating to the Group's pension deficit. As reported in the 2019 Half-yearly Report, following agreements reached in respect of overseas tax matters, a one-off non-cash benefit was recognised to 2019 earnings per share, net of a provision taken in respect of the estimated exposure arising from the EU's decision regarding the UK's Controlled Foreign Company regime. The Committee considered the related disclosures (see page 46).

How we ensure that the Group's Annual Report, taken as a whole, is fair, balanced and understandable and provides information necessary for shareholders to assess the Company's position and performance, business model and strategy

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.

Going concern and viability statements

The Committee also agreed the parameters of, and subsequently reviewed the supporting report for, the going concern statement (see page 90) and the statement on the Board's assessment of the prospects of the Company (see the viability statement on page 89) over the five-year period used in the Integrated Business Plan. The Committee considered the period covered by the viability statement, and whilst a number of companies have elected to use a three-year horizon, we continue to be of the view that a five-year period remains the most appropriate timespan for this Group.

Stephen Pearce
Chairman of the Audit Committee

FRC letter

The Company received a letter from the FRC which confirmed that it had undertaken a review of the Group's Annual Report for the year ended 31 December 2018 and had no questions or queries that it wished to raise at that time. We have noted the suggested enhancements that could be made to certain of our disclosures and these have been appropriately addressed in the Annual Report 2019. We thank the FRC for their input.

The Audit Committee's year

Feb London, UK

Committee

- Considered the accounting, financial control and audit issues reported by the auditor 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 Tax 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].

Joint session with the Corporate Responsibility Committee:

- Agreed final iteration of the 2019 Internal Audit programme.

Jun Washington DC, US

Committee

- Agreed external audit strategy and scope.
- Reviewed external auditor independence issues.
- Agreed external audit engagement letter and fee.
- Considered output of the Internal Audit Director's report.
- Received a presentation from VP, Internal Audit, for the US businesses.
- Regular quarterly items[1].

Jul London, UK

Committee

- Considered the accounting, financial control and audit issues reported by the auditor that flowed from the half-year review work.
- Reviewed the financial statements and specific disclosures, including going concern, for recommendation to the Board.
- Received a presentation from senior finance representatives in the Company's Saudi Arabian business on financial controls and governance.
- Received a report from the Group Tax 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

- Informal meeting with the Internal Audit Director and external auditor to discuss a range of issues including the future direction of financial auditing and the scope, skilling and resourcing of internal audit.

Dec London, UK

Committee

- Considered the external auditor's controls report.
- Considered output of the Internal Audit Director's report.
- Received a presentation from Chief Information Officer.
- Reviewed Internal Audit Charter.
- Received a report on export control compliance.
- Reviewed the Non-Audit Services Policy.
- Discussed the first iteration of the 2020 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.
- Review of the Committee's Terms of Reference.
- Regular quarterly items[1].

Committee composition and evaluation

Nick Rose and Paula Rosput Reynolds served as Committee members throughout 2019, stepping down on 31 December 2019. Stephen Pearce and Dame Elizabeth Corley were appointed as Committee members with effect from 1 January 2020.

The breadth of experience of the Audit Committee members is set out on page 87. 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, skills and experience to discharge its responsibilities.

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 auditor without management present. The Audit Committee Chairman also meets separately with internal and external audit on an ad hoc basis.

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-tendering disclosures. The last audit tender undertaken concluded with the appointment of Deloitte LLP in May 2018.

Audit Committee timeline

- February — Committee
- June — Committee
- July — Committee; Meeting
- December — Committee

Corporate Responsibility Committee report



Ian Tyler Chairman of the Corporate Responsibility Committee

Members

Ian Tyler (Chairman)

Revathi Advaithi

Chris Grigg

Dear Shareholders,

I reported last year that in 2019 the Corporate Responsibility Committee would be taking on an employee engagement role as detailed in the revised UK Corporate Governance Code, and 12 months on I am pleased to be able to report on this activity below. During the year, we also maintained our oversight of other corporate responsibility-related matters, with a particular focus on safety, diversity and inclusion, responsible business conduct and supplier conduct.

Harriet Green was a member of the Corporate Responsibility Committee for eight years up until she retired from the Board in November last year. I would like to thank her for the excellent contribution she made to the Committee during that period.

Workforce engagement

With effect from this year, the revised UK Corporate Governance Code (the Code) requires that boards have a method by which they can engage with their workforce. Having considered this requirement, the BAE Systems Board agreed that the most appropriate and effective means of achieving this was for the Corporate Responsibility Committee to take on this responsibility.

This decision was taken on the basis that engaging with employees has always been a key part of the Committee's remit since it was first formed. In the past, we have used different methods to engage and understand how effective the Company is in managing issues such as employee conduct and behaviour, employee safety, and workforce diversity and inclusion. The governance structure of the Committee is also important, with its membership being entirely non-executive – and therefore having the same independence characteristics as would be achieved by appointing a single non-executive director (one of the methods of workforce engagement suggested by the Code). Due to the Company's complexity, wide geographic spread and size – 87,800 employees spread across more than 40 countries – there are clear advantages to the role being performed by more than one director.

From 2019, the Committee's terms of reference were amended to reflect the requirements of the Code regarding engagement with the workforce. However, from the start the Company has always been well placed to discharge this responsibility, with the Board and the Committee regularly visiting Company sites and meeting employees in previous years, and also through activities such as my participation in the Company's UK Trade Union Forum.

The Committee's programme of activities has been enhanced further to ensure we undertake our employee engagement responsibilities effectively, and we will continue to listen to our employees to understand what matters to them and evolve the focus of our activities as necessary to reflect this. In addition, as this is a new Code requirement, we will monitor how best practice evolves across UK listed companies and develop our approach accordingly.

The obvious challenge for the Committee in discharging this new responsibility was, as mentioned above, the size and international spread of our workforce. That said, there are certain broad similarities: our workforce is largely employed directly rather than on a sub-contract basis; and our defence businesses are characterised by large numbers of skilled manual and engineering roles – typically with high long-term retention rates.

In analysing how it should go about discharging this new workforce engagement responsibility, the Committee agreed that it was important to understand the Company's approach to employing people – the policies and processes, behavioural expectations and ultimately the culture we want to see in our places of work. The approach we agreed has been to learn from senior executives about these matters and their expectations, and also hear from operational managers on the practical application of workforce policies. We have engaged directly with employees largely via site visits that provide opportunities for one-to-one and group engagement. Indirectly, we have also analysed the feedback from employee opinion surveys, and other data evidencing employee opinion and sentiment. Taken together, these forms of engagement have provided a useful balance between personal engagement with a relatively small number of our total workforce, and wider but more limited engagement with a large part of the total.

Corporate Responsibility Committee report
continued

The following provides more detail of this activity as undertaken as part of Board and Committee activity during 2019, and personally by me in my capacity as Chairman of the Committee:

Engagement on workforce matters
Employee conduct and ethics
Executive behaviours
People development and succession planning
Diversity and inclusion
Health and safety
Direct workforce engagement
Site visits: – Electronic Systems – Endicott, US (town hall meeting, workplace engagement, informal engagement with employees) – Submarines – Barrow-in-Furness, UK (town hall meeting, workplace engagement, informal engagement with employees) – MBDA – Stevenage, UK (workplace engagement, informal engagement with employees) – Ordnance Systems – Radford, US (workplace engagement, informal engagement with employees) – Ship Repair – Norfolk, US (workplace engagement)
Breakfast meetings with high-potential employees without senior management present – March, July
Attendance at Company graduate workshop
Engagement with employee representatives
Meeting with trade union representatives through the UK Trade Union Forum

For non-executive directors, first-hand experience of the Company is vital, and the Board, the Committee and individual directors undertook a number of visits to Company sites during 2019. Employee engagement is a key part of the experience, and whilst this only provides a snapshot of the Company, in aggregate such visits when supplemented by committee room analysis and discussion, can provide insight into the Company's employment culture and the nature and condition of our employee offering.

During the year, we heard a range of employee voices expressing clear views on different topics, from the strategic to the local. Access to employees was open and direct, and undertaken across a variety of businesses and sites in the UK and US with different working environments. We listened and we learnt, and it all helped to broaden our understanding of the workforce environment and culture within BAE Systems, and also the views of employees and what really matters to them.

Safety

The Committee has maintained a clear focus on workplace safety over a number of years, having set a clear overall objective of continuing to drive towards a world-class level of performance. Safety performance is part of the non-financial element of the Company's annual incentive plan for senior executives. The Remuneration Committee looks to the Corporate Responsibility Committee to set the measures for the plan, and to determine the level of performance achieved against these. Five percent of the maximum amount payable to participants under the annual incentive plan is based on the Committee's assessment of performance against safety, and diversity and inclusion metrics.

It is disappointing that we saw a reduction in the level of safety performance in 2019, as assessed against the measures set by the Committee. As in past years, as part of the safety metric, we targeted an improvement of 10% in the level of recordable injuries but only achieved a 0.2% improvement (2018 16%) last year. We also look at the level of major injuries, and 38 such incidents were recorded in 2019 (37 in 2018). Consequently, there will only be a small payout under this element of the annual incentive plan for any of our executives. The Company's businesses responded to the lack of improvement in safety performance and have taken actions that will feed into this year and beyond.

The Committee continued to meet with senior executives to review the actions they are taking to drive safety performance. Last year we undertook such reviews of our US business and also the UK-based Maritime businesses. In the US, management has taken further action to improve safety, particularly around the analysis and management of risk and focusing on the all-important cultural aspects of safety management. In Maritime, we saw similar action being taken on safety leadership and the use of workplace stand-downs to engage with all employees on safety management. The business also engaged an independent safety expert to review and advise on remedial activity to improve performance.

Diversity and inclusion

The Board is committed to BAE Systems being an inclusive organisation with a diverse workforce that reflects the global communities in which we work. Developing an inclusive and diverse workplace that helps all employees contribute their unique experiences, beliefs and insights will help drive innovation, enhance employee engagement and accelerate our performance. The Company's management team has increased its focus on achieving a more diverse and inclusive workforce, in particular we welcome the adoption of clear, common diversity and inclusion objectives, and a programme of activity aimed at improving our performance in this area.

We have also aligned part of the annual incentive plan for senior executives with the following diversity and inclusion objectives:

- attract and retain a diverse workforce that reflects market availability at all levels of the organisation; and
- advance an inclusive workplace where leaders can retain key talent effectively and employees feel that their differences are valued and intentionally leveraged.

To achieve these objectives, the Chief Executive has set key actions for executives. These target the increased representation of women in senior roles in each market by market availability. Also, our senior leaders are required to act as visible advocates and support inclusion by actively participating in at least two targeted activities/events. In the US, assisted by local regulations, we have good visibility of the level of diversity within our workforce but it is more difficult in the UK and elsewhere, where diversity data can only be collected if employees provide this information voluntarily. As a result, to enable our objectives, we launched a campaign to encourage employees to provide more information about themselves and thereby help us understand more about the demographics of our non-US workforce.

In June, the Committee undertook a review of diversity and inclusion activity in our US business, which, with approximately 30,000 employees, is a significant part of our total workforce. We were pleased to see that progress was being made in driving the required change in culture. Also, we heard about the tools being used to support our analysis of diversity data, relative to the external availability of jobs by location. We use this analysis to drive more focused actions at the work team level. In addition, we learnt about the introduction of Coaching Circles, which facilitate the convening of a diverse group of four to six leaders that are able to discuss different diversity and inclusion topics and provide support in navigating issues that may arise.

Part of the executive annual incentive plan is based on performance against the diversity and inclusion measures set by the Committee. In 2019, the measures were based on:

- focusing on the intake and advancement of women at all levels in the Company;
- increasing the number of senior executive female roles by accelerating development and external appointments; and
- working towards the achievement of a culture shift to create an inclusive workplace.

In summary, the specific measures were:

- increasing the representation of women in senior roles by each market;
- in the US, to decrease the attrition of under-represented groups by reducing disparity against the applicable comparator group. For businesses outside of the US, to increase the number of employees self-identifying, on a voluntary basis, certain matters associated with diversity – and thereby helping to provide a basis on which we can make informed assessments of our progress in achieving a more diverse workforce; and
- senior leaders acting as visible advocates of diversity and inclusion, and supporting inclusion by actively participating in targeted events and activities during the year.

Product Trading Policy

The application of our Product Trading Policy has been mandated by our governance framework and the Board and requires an evaluation to be undertaken on all potential new products and trading services to ensure that we only undertake such business consistent with our Responsible Trading Principles. The Committee regularly reviews compliance with this policy, as reported through our Operational Assurance Policy, and also looks closely at how it is being operated and applied to particular products and services. Our review during the year focused on the application of the Product Trading Policy from the identification of an opportunity through to contract award, which often takes place over a number of years. We also looked at how product trading considerations are applied when dealing with joint venture partners.

As part of the Committee's oversight of the application of the Product Trading Policy, it also reviewed the findings of the Court of Appeal for England and Wales with regard to the judicial review action brought against the UK government in respect of the granting of defence export licences for Saudi Arabia.

Looking forward

In 2020 the Committee will continue to focus on the areas of corporate responsibility detailed above. We will also be spending more time reviewing resource efficiency and the Company's approach to, and reporting on, sustainability.

Ian Tyler
Chairman of the Corporate Responsibility Committee

The Corporate Responsibility Committee's year

Feb London, UK

Committee

- Reviewed safety performance in 2018 relative to the objectives set by the Committee and made recommendations to the Remuneration Committee concerning the element of the annual incentive plan subject to this measure.
- Considered the feedback from our global employee engagement survey and the actions being taken in response to issues raised.
- Agreed the safety, and diversity and inclusion annual incentive targets.
- Agreed a programme of employee engagement activities for the year.
- Agreed the Company's Modern Slavery Act Response.

Jun Washington DC, US

Committee

- Reviewed how the Company was working towards a more diverse and inclusive workforce and the actions being taken to achieve this. This included a more detailed review of our US business.
- Reviewed workforce safety performance across the Group, looking at the incidents of major and recordable injuries by business, and also undertaking a deeper review of the management of safety within the Platforms & Services (US) business within BAE Systems, Inc.

Sep London, UK

Committee

- Reviewed the safety performance of the UK Maritime businesses and the actions being taken to drive continuous improvement.
- Considered the application of the Company's Product Trading Policy to long-term new business opportunities, and how the Company looks to ensure that it remains compliant with the requirements of the Policy during this period.
- Based partly on the feedback received following employee engagement, the Committee reviewed the work being undertaken with regard to executive behaviours, organisational design and workplace culture.
- Received a presentation from our Audit Director reviewing the responses to certain corporate responsibility-related matters covered by our Operational Assurance Statement process.
- Received a report from the Government Relations Director on political lobbying activity undertaken during the year and compliance with related regulatory requirements.

Dec London, UK

Committee

- Reviewed how the Company's Procurement function is implementing responsible business practices within our supply chain.
- Received a report on the application of the Company's Adviser Policy and associated compliance activity.
- Considered the findings from work undertaken by the Company's Internal Audit function concerning corporate responsibility-related matters.
- Agreed the corporate responsibility-related objective to be used for the executive annual incentive plan in 2020.
- Agreed the Committee's programme for 2020 (see below).

Schedule for 2020

February
- Review of 2019 performance metrics.
- UK workplace safety deep-dive.
- Application of the Product Trading Policy.
- Review and approval of Modern Slavery statement.

June
- Review of anti-bribery and corruption processes.
- US workplace safety deep-dive.
- Diversity and inclusion activity and performance.
- Employee wellbeing and workplace culture.

September
- Workforce and stakeholder engagement.
- Triennial review of Code of Conduct.
- Application of the Product Trading Policy.
- Approach to sustainability.
- Review of future Committee activity.

December
- Review of the Advisers Policy.
- Workforce and stakeholder plan.
- Responsible procurement.
- Corporate responsibility-related performance objectives.

Corporate Responsibility Committee timeline

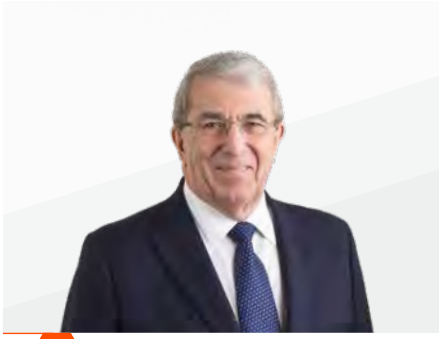
February — Committee

June — Committee

September — Committee

December — Committee

Nominations Committee report



Sir Roger Carr Chairman of the Nominations Committee

Members

- Sir Roger Carr (Chairman)
- Revathi Advaithi
- Dame Elizabeth Corley
- Chris Grigg
- Stephen Pearce
- Nicole Piasecki
- Paula Rosput Reynolds
- Nick Rose
- Ian Tyler

Dear Shareholders,

The Nominations Committee continued to review, develop and implement succession plans for both executive and non-executive Board members throughout the year.

As part of this process, last year we carefully evaluated the current and planned Board structure recognising that a number of experienced and valued executive and non-executive directors were due to retire over the next 12 months. Against this background, I wish to share our analysis of the current Board, committee structure and membership, and our plans for the future.

Board composition

The Board currently comprises myself as Chairman, three executive directors and eight non-executive directors. My analysis of where we are at present is as follows:

- we have a high-quality and diverse mix of individuals, with women comprising one-third of Board membership, and with nearly the same level of non-British directors;
- around the board table we have a good combination of skill, knowledge and experience, with individuals bringing international business, finance, engineering, public company board and long-term contracting experience (see the chart below);
- during the year, we have added to this mix with the recruitment of Nicole Piasecki, a former senior aerospace industry executive, who brings considerable defence and aviation industry knowledge to the Board, and Stephen Pearce, a seasoned finance director from the mining industry with international business and boardroom experience; and
- time served on the Board has also been carefully considered and we currently have a good balance of experience (see analysis on page 88).

The Nominations Committee is aligned to the Company's strategic objective of achieving greater diversity and, at Board level, diversity of background and thought to widen the aperture of our strategic discussions and decision-making. Our policy is to continue, over time, to create a Board that not only brings together individuals with the right balance of skills, knowledge and experience, but also a Board that is reflective of the multinational nature of the global markets in which we operate. To help us achieve this, we continue to work with search consultants to develop a diverse succession pipeline. We have made progress and are on course to achieve the target set by the Hampton-Alexander Review, with women comprising one-third of Board membership currently. We are also well placed to meet the recommendations of the Parker Review Committee concerning ethnic diversity.

The work the Committee undertakes on executive director succession planning is an integral part of the Company's activities on pipeline and leadership development. During 2019, the Board reviewed the strategic workforce planning work being led by our Chief Executive and Group HR Director. This is a long-term commitment, with particular focus being placed on employees in middle-management positions, and how we identify and assess their potential to be future senior leaders and then target development activities and opportunities to accelerate their careers. Diversity and inclusion is an important part of this work. In general, we continue to see an increase in gender diversity across the Company, and 34% of the group comprising our senior management (as defined by the Code) and their direct reports are women. At present, there is only one woman on our Executive Committee, and whilst we only make appointments on merit, with the executive pipeline and diversity and inclusion actions we have in hand, I believe that over time we will succeed in achieving a more diverse leadership team.

Skills and experience



Due to the nature of our business, we have to be compliant with certain UK and US governmental requirements when it comes to Board appointments. Our ownership of US defence businesses is governed by a Special Security Agreement (SSA) between the United States government and the Company. This requires that the board of our principal US Company, BAE Systems, Inc., provides oversight over the application of the SSA, including matters concerning the appointment and role of the President and Chief Executive Officer of BAE Systems, Inc., who also sits on the BAE Systems plc Board.

Board changes

In November last year, Harriet Green retired from the Board having served a full nine-year term. Harriet made a material contribution in strategic, operational and diversity discussions throughout her tenure.

Nick Rose will retire from the Board at the end of March. He is currently our Senior Independent Director and handed over the Chairmanship of the Audit Committee to Stephen Pearce at the beginning of the year. He has been an outstanding Board member, thought leader and support to me as Chairman and to Board colleagues throughout his time on the Board. He will be much missed by all. The Committee has agreed that Chris Grigg should succeed Nick as Senior Independent Director with effect from 1 April 2020. Chris has served on the Board for over six years and has strong business and boardroom credentials.

This year will see significant change with regard to the executives on the Board, with Peter Lynas, Group Finance Director, and Jerry DeMuro, Chief Executive Officer of BAE Systems, Inc. both retiring at the end of March.

We announced last December that, with effect from 1 April 2020, Tom Arseneault, currently the President and Chief Operating Officer of BAE Systems, Inc., will succeed Jerry as head of our US business and join the Board. Tom's appointment will be the culmination of Board executive succession planning and development activity going back a number of years. We also announced in 2019 that Brad Greve will succeed Peter Lynas as Group Finance Director, with effect from 1 April 2020. He was recruited last year from a senior financial role at Schlumberger and will have worked alongside Peter for over six months before succeeding him. Buchanan Harvey was engaged by the Committee to assist in his recruitment.

Succession planning

Paula Rosput Reynolds will shortly have completed nine years as a non-executive director. She currently serves as a highly-valued Chair of the Remuneration Committee and is considered an important contributor of corporate knowledge and wisdom by fellow Board members. Following consultation with our principal shareholders, the Committee agreed that her term of office should be extended for a further 12 months to April 2021.

In recognition of the requirement in the Code for 12 months' experience, Ian Tyler has joined the Remuneration Committee, as it is our plan that he will succeed Paula as Chair of that committee next year.

We will be looking to make further non-executive director appointments in 2020.

Evaluation

During my time as Chairman, the Board has adopted the practice of using an external facilitator every two years, with an internal process used in the intervening period. We have just completed an externally facilitated evaluation, and this is detailed on page 101.

Summary

During the last three years, the Nominations Committee has successfully identified and recruited six talented and experienced executive and non-executive directors from both inside and outside the aerospace and defence sector to provide fresh perspectives and experience when blending with the seasoned talent embedded within the organisation.

Members of the BAE Systems Board continue to add material value to the governance, strategic planning and operational delivery of the company. It is with considerable sadness, therefore, when we lose any Board members, but we will continue to respect and adhere to only modest extensions to their term when deemed appropriate by the Nominations Committee and with the support of our shareholders.

Sir Roger Carr
Chairman of the Nominations Committee

Board evaluation

Facilitator
Led by Ffion Hague of Independent Board Evaluation (IBE), an independent consultancy working exclusively on board effectiveness reviews. IBE provide no other services to the Company.

Period of evaluation
December 2019 to January 2020 with Board feedback and review taking place at a Board meeting held on 19 February 2020.

Evaluation process
Externally facilitated assessment of the Board, its committees and individual directors, conducted in accordance with best practice guidance. All Directors were interviewed individually for approximately 90 minutes by the facilitator as part of the process, as were a number of senior executives who support and contribute to Board matters. The evaluation covered the following:

Board
- Board accountability
- Shareholders and stakeholders: communication and relationship
- Strategy: development, oversight and implementation
- Governance and regulatory compliance
- Board focus and priorities
- Risk management including non-financial risk
- Succession planning
- Composition of board – skills, diversity, experience
- Board culture
- Teamwork/collegiality
- Relationship with executive leadership team; employee engagement
- Decision-making; time management, objectivity
- Selection and induction of new members
- Evaluation of Director performance
- Meetings: frequency, quality, duration and organisation
- Quality of papers and presentations
- Resourcing levels: timeliness of papers, support functions

Board Chairman
- Quality of contribution and Board leadership
- Independence and objectivity
- Understanding of role/other roles
- Monitoring of implementation/ follow-up actions
- Chairing skills and agenda setting
- Relationships with Chief Executive/ other directors/executives
- Communications with non-executive directors outside of board meetings
- Time commitment

Individual Board members
- Individual 'unique' roles
- Quality of contribution
- Skills, experience, competence
- Time commitment
- Understanding of the business
- Preparedness for meetings
- Relationship with other directors
- Understanding of non-executive/ executive roles
- Currency of knowledge and perspective

Feedback
A comprehensive report was produced by IBE, which was provided to directors ahead of the board meeting at which the principal findings were presented by Ms Hague. Among other things the report covered strategy, governance and compliance, risk management, succession planning, board composition, board culture, decision-making and directors' induction.

The Chairman will provide feedback from the evaluation to individual directors. The Senior Independent Director will provide feedback on the Chairman's own performance after he has met with all the non-executive directors to consider the material provided by IBE.

Resulting Actions
- Developing a crisper articulation of the Company's long-term strategy beyond our five-year planning period.
- Allocate more time to culture, purpose and behaviour in board discussions.
- Conduct deep dives into matters such as cyber security, and use this as an opportunity to engage more fully with the relevant senior executives.
- Implement greater connectivity between individual executive directors and non-executives for advice, guidance, informal discussion and relationship building.
- Provide more opportunity for face-to-face contact between non-executive directors and customers.

Nominations Committee timeline

January	February	March	May	December
Committee	Committee	Committee	Committee	Committee

Remuneration Committee report



Paula Rosput Reynolds Chairman of the Remuneration Committee

Members

- Paula Rosput Reynolds (Chairman)
- Dame Elizabeth Corley
- Chris Grigg
- Nick Rose
- Ian Tyler

Dear Shareholders,

With all the attention paid to remuneration policy by the UK government and shareholder organisations, it is sometimes challenging to develop a balanced perspective on the usefulness of all the changes being implemented or recommended. Fortunately, 2020 marks the second time that I have been through the policy restatement cycle for BAE Systems as Committee chair and my colleagues, Nick Rose and Dame Elizabeth Corley, have similarly had longevity in their roles on the Committee. I am also pleased to welcome Chris Grigg and Ian Tyler, who have joined the Committee this year. Together, we believe we come to our responsibilities with measured views and perspectives that have been shaped by the elevated external interest in remuneration.

There are several themes which we have seen emerge and which we view positively as a result of this interest in remuneration. First, is the quality of consultation with our shareholders. Along with our Chairman, we have an ongoing dialogue, not just with our largest shareholders, but with other shareholders on the register who have expressed interest in particular issues. Over the last several years, those conversations have become more frequent, more engaged and more focused on joint problem-solving. From those conversations we find more openness to remuneration policies that are fit for BAE Systems.

New ideas are being discussed, and fewer prescriptive solutions are being recommended. Indeed, the elevated interest on the part of shareholders and government has led to better communication among us.

The second theme which we have seen is the agreement that remuneration should be more closely aligned to the Company's strategy. The financial targets remain the most easily understood and communicated, but stakeholders increasingly recognise that there is a trade-off between simplicity of financial metrics and the granularity that comes with ensuring that strategy is well-executed. Consequently, there has been support for the Remuneration Committee evaluating strategic progress on dimensions other than financial measures. Our Chief Executive has been clear about the importance of product quality, efficiency, productivity, digitisation of business processes, and advances in technology. These elements are less easily measured, yet are critical to the sustainable performance of BAE Systems. Thus, of late, we have consulted with shareholders to develop parameters for measuring strategic progress.

We appreciate the growing sentiment that keeping track of these dimensions may be complicated, but it is essential. We also appreciate the confidence that shareholders have expressed in the Remuneration Committee as we embark on measuring strategic progress; we will be rigorous and shareholders can be assured that the Committee will not confer unearned rewards.

The third theme we have observed is that there has been greater engagement on the mechanics of our remuneration scheme. Several years ago, shareholders focused on the 'single figure' of the three executive directors. Today, there is acknowledgment that the single figure does not necessarily tell the story for those executives and that there is more to rewards than a headline figure. We have had detailed discussions about the fitness of constructs, such as relative Total Shareholder Return (TSR), and whether they are useful, and how cash flow, an important element in our distribution policy, should be measured. We have also found that shareholders with whom we have met see the bigger picture – namely, that remuneration at the top of the organisation is part of a programme of remuneration for the wider workforce. Whatever incentives are in place for the most senior executives need to make sense throughout the organisation, must create proportional rewards for those who contribute to the Company's success, and when we make changes, they must be understood and embraced throughout the organisation. Consequently, we are talking about rewards more holistically now than in the past.

Lastly, we have found support by shareholders for use of discretion by the Remuneration Committee. The idea of a purely formulaic approach to remuneration has lost favour. We are hopeful that the communication between the Remuneration Committee and shareholders has engendered trust in the Committee. Indeed, my colleagues and I do understand the environment in which we are asked to undertake our deliberations. We hope we continue to demonstrate that this Committee is easily approached, that we readily seek input and that we are influenced by what we learn in discussions.

The year in review

The past year has been one in which there have been a number of leadership changes throughout the organisation as the Board and the Chief Executive have sought to renew the leadership to carry the Company into the future. These changes have also given the Remuneration Committee opportunity to implement some of the remuneration changes required by government and shareholders ahead of required timetables, including moderated quantum and reductions in pension allowances.

Two executive director changes are noteworthy. Brad Greve has been appointed Group Finance Director designate to succeed Peter Lynas who retires after a distinguished career of over 35 years with BAE Systems, including nine years as Group Finance Director. Peter will retire on 31 March 2020 and Brad will become Group Finance Director and a member of the BAE Systems plc Board on 1 April 2020. Tom Arseneault will succeed Jerry DeMuro as President and Chief Executive Officer of BAE Systems, Inc. Tom will join the BAE Systems plc Board on 1 April 2020 as Jerry steps down from his board position. Jerry will remain engaged in several key projects before retiring on 31 December 2020. The retirements of Peter Lynas and Jerry DeMuro are both being handled precisely according to our approved Policy. In addition, both directors have voluntarily agreed to a post-cessation shareholding requirement to apply following their departure.

Over the course of 2019, the Remuneration Committee conducted an extensive review of the effectiveness of our currently-approved 2017 Remuneration Policy. We started with a 'blank sheet of paper' to be sure we were bringing fresh thinking to the process. In terms of overall design principles, our review confirmed that the current three-part construct of base salary, annual incentive and long-term incentives (LTIs) remains appropriate. As we looked at alternatives, we could not find value in changing that construct given the specific purpose each element is designed to play. Moreover, to initiate a structural change to the three-part structure, given its prevalence throughout our senior executive framework, as well as within the industry, was deemed needlessly disruptive.

Nevertheless, we do believe that some fine tuning of our Remuneration Policy and structure is in order. The Committee strongly believes that the best way to achieve positive financial results for shareholders is to adopt measures which explicitly reward achievement of carefully selected and rigorously measured strategic imperatives. In other words, if we agree on the right actions in the short run and over the three-year performance cycle, the financial rewards for shareholders will also be achieved. With this perspective in mind, we are asking shareholders to consider adjustments to our Policy that are more in keeping with the emphasis on total performance. We are seeking approval of our 2020 Policy at the Company's Annual General Meeting (AGM) in May 2020.

Context to the Committee's decisions

The business environment in which BAE Systems operates is a challenging one. There are the geopolitical realities of the industry in which we operate and the customers with whom we do business. There is the technical complexity of the work we do and the need for constant invention to make our businesses thrive. There is the competitive environment in which we acquire and retain talent, including the security of our work. All of these factors make us mindful of the importance of a highly skilled and experienced workforce, that it constantly be replenished with next-generation talent, and that the organisation be properly led and given the right performance incentives. While the Committee remains responsible for the full spectrum of senior executive employment matters, we also have a responsibility to ensure that the wider workforce across the globe is being treated equitably. Performance regarding safety, diversity, inclusion, gender pay differences, and pay practices around the world are all factors that are considered as we make our decisions.

The primary tool we use to steward the business is through the incentives we adopt for those employees with leadership responsibilities. Our overall remuneration framework has a number of specific goals. Our short-term programme metrics are tied to Group performance, business segment performance and individual goals, including the behaviours that underpin BAE Systems' culture. Starting in 2018, working with our Chief Executive, we considerably expanded the individual goals of our leaders. This enhancement has led to greater rigour in evaluating their contributions and also has been a catalyst for a culture change of greater individual accountability throughout the organisation. Our current long-term incentive programme measures absolute performance of the Group and performance relative to peers.

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 engages in a discussion regarding 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. With the enhancement in individual goals now firmly in place, we have the basis on which to exercise greater judgement in evaluating the performance, contributions and potential of our executives.

2020 base salary review

Turning now to decisions taken on the 2020 base salary review, our Chief Executive, Charles Woodburn has been in role since July 2017. Under his leadership, the Group has achieved a number of significant contract wins including the Australia Hunter Class Frigate programme and Canadian Surface Combatant programme, and Qatar Typhoon, resulting in the achievement of a record high order backlog with visibility on many of our key programmes through this decade. He has also been leading a comprehensive change in strategy, culture, leadership and values, all of which reflect well on the stature he has earned as our Chief Executive.

Recognising the fact that the Committee appointed Charles on a salary significantly below that of his predecessor, the significant performance achievements that have been enabled under Charles' leadership and the criticality of Charles' efforts to ensure there is a robust leadership team for the future, it is applying a one-off adjustment to the Chief Executive's salary that exceeds the percentage indicated for the wider workforce. Reflecting Charles' skills, time, performance and experience, the Chief Executive's salary has been set at £980,000 with effect from 1 January 2020. This represents a 6.58% increase and positions his salary just below that of his predecessor. While the Remuneration Committee does not rely on benchmarking in making its salary determinations, it does mean that the new salary is positioned around the median in relation to the external market, which is in keeping with our policy.

The Committee confirms that there will be no salary adjustment for Peter Lynas, Jerry DeMuro or Brad Greve as at 1 January 2020. On his appointment to President and Chief Executive Officer of BAE Systems, Inc., the salary of Tom Arseneault will be $980,000, which is approximately 10% below his predecessor. The Committee would consider closing this differential in the first two years, dependent on Tom fully meeting our expectations in the new role.

2019 incentive outcome

After the close of 2019, the Committee met and reviewed performance under the short-term annual incentive for all of the executive directors and Executive Committee members. Financial results were achieved at or around stretch; non-financial achievements varied for the executive directors and Executive Committee members and were predominantly between target and stretch.

As set out in our report, the 2019 fully diluted underlying EPS is 45.5p. This figure excludes the one-off benefit of 5.0p. The Committee exercised its discretion and agreed that the final incentives' vesting outturn should reflect the 2019 fully diluted underlying EPS result including the tax benefit. Our reasoning was as follows. First, the tax agreement was achieved as a result of long-term executive engagement with authorities and counter-parties and would not have been achieved without those efforts. Second, over the years, management prudently provided for the possibility of an adverse resolution, thereby reducing earnings and earnings growth in prior performance periods in which we measured long-term performance. Third, the resolution of the matter takes away a significant financial uncertainty and will improve the Company's future earnings potential. Fourth, this benefit comes in addition to an otherwise excellent year of performance where management has delivered superior results overall.

The Committee used its judgement in evaluating non-financial performance, including the executives' commitment to safety, diversity and inclusion, as well as overall leadership contributions. A discussion of that evaluation and the bonuses earned by the executive directors are reported on pages 122 and 123.

The Performance Shares granted in 2017 under our long-term incentives will partially vest in early 2020 as will the Restricted Shares granted to our US executive director. The details of the vesting outcomes and amounts awarded are also described in the following report.

Having thoroughly reviewed annual and three-year performance, relative to the remuneration outcomes, the Committee is satisfied that the Policy operated as intended during 2019, aside from TSR performance against the peer group. As set out above, we are proposing to make adjustments in the 2020 Policy to place greater emphasis on the attainment of strategic goals.

Rationale for the 2020 remuneration policy requiring approval at the 2020 AGM

The Remuneration Committee is not proposing any changes to the target or maximum annual incentive opportunity or LTI award levels. The changes we are asking you to approve are set out below.

Operation of non-financial measures within the annual incentive

Our currently-approved construct of the annual incentive provides a split between financial and non-financial measures, with the discretion of the Committee to determine the metrics and weightings on an annual basis according to business priorities. Under the proposed Policy, the split of financial and non-financial performance measures within the annual incentive will remain at 75%/25% respectively. The annual financial targets will continue to be set so as to align with the long-term earnings and cash targets. The 25% non-financial element will continue to be based on a combination of personal performance objectives that provide clear line of sight to our strategic objectives.

The one change we believe is warranted is to remove the safety, and diversity and inclusion (D&I) elements from the target and instead apply these elements as 'underpins' of the total annual incentive outturn. We value the highest levels of safety as well as the commitment to D&I as critical to the business. But we have also heard from shareholders that these matters – which are as much a reflection of culture as they are of performance – should be 'table stakes' for executives. In other words, being a safe and inclusive workplace is expected as part of the top executives' day-to-day performance. Therefore, to administer the underpin, the Remuneration Committee, along with the Corporate Responsibility Committee, will continue to review performance and progress on safety, and D&I. However, from 2021 forward, we will use our discretion to modify the annual award in a downward direction if we find that safety and/or D&I are not up to the high standards we expect of our leadership.

As a consequence, the non-financial element will continue to be weighted at 25%.

Adjust LTI metrics to align with strategy

The Remuneration Committee believes that reference to the external market is important in setting LTI targets. The 3%-5%-7% EPS growth target is one market-facing reference and we intend to maintain this EPS range. This range has proved challenging over recent three-year cycles. Nevertheless, a number of shareholders have expressed their support for maintaining this target in light of global spending on defence and the potential for business process improvement. To this financial measure, we propose to add a three-year cumulative cash generation measure to give weight to the fact our earnings must be underpinned by ample cash to support dividends and reinvestment in the business. We believe these two measures – the target EPS growth rate and cumulative cash generation – capture our financial ambitions for the business.

Looking at the totality of our LTI construct however, we do not believe the balance between external financial measures and company-specific measures is properly calibrated. Specifically, we have been concerned over this last cycle that our LTI structure is not creating meaningful incentive to drive specific performance due to the 50% weighting on relative TSR. The Committee proposes to reinforce the Chief Executive's efforts to strengthen the culture of continuous improvement by reducing the portion of the LTI weighting accorded to TSR and including a metric which reflects strategic progress. The Committee intends to set quantifiable targets which will apply to LTI awards made from 2021 onwards against our three key strategic goals as described below.

Drive operational excellence: The focus of this objective is the adherence to project plans of our mission-critical projects, delivering them on a timely basis, with quality, and at target or better margins and over the three-year performance period for key programmes such as the F-35, UK Typhoon, the Saudi support programme, production of the Type 26 frigate in the UK and Australia, a portfolio of electronic warfare programmes and the combat vehicle production programmes. Performance will be determined chiefly by measuring the aggregated net margins of the critical projects. In addition, the Committee will take into account the timeliness of delivery and quality of the products and services as it determines whether the strategic goal of operational excellence is being achieved.

Continuously improve competitiveness and efficiency: The primary aim of this objective is to improve the agility and long-run sustainability of the Group's business by enhancing the efficiency and effectiveness of the organisation. To do so, the Committee will examine various measures of cost and investment efficiency through a collection of key metrics that are indicators of organisational effectiveness such as return on capital employed and reduction of overhead and administration expense as a percentage of sales as appropriate for the various businesses.

Advance and leverage our technology: To be successful in the highly competitive markets in which it participates, BAE Systems develops and leverages advanced technology to discriminate our products and services to support customers around the world. The Company also leverages emerging digital technologies internally in its operations and processes to drive efficiency and higher throughput. The Company will evolve its portfolio by investing in technology and securing customer investment to improve its products and services as well as the efficiency of its operations. The Committee will monitor the Group technology plans and success in addressing strategic market opportunities and modernising operations.

While retaining the ability within the Remuneration Policy for the Committee to determine performance measures, weightings and targets on an annual basis, and the flexibility to vary the weighting and mix of LTI awards, for the 2021 awards we are therefore proposing the following:

Direct financial measures	
EPS growth	25%
Cash generation	25%
Strategic measures	
Relative TSR performance	25%
Strategic progress	25%

Shareholding requirements

The Committee acknowledges the relevant provisions of the 2018 UK Corporate Governance Code (the Code), as well as broader expectations of investors in relation to the Minimum Shareholding Requirement (MSR). The Committee has already agreed a policy whereby executive directors are required to establish and maintain a minimum personal shareholding. In addition to maintaining this policy, the Committee proposes to introduce a five-year time period in which executive directors are required to achieve their MSR.

The current policy already contains consequences for the executive directors not meeting their MSR, which is a restriction on the number of shares that can be sold on exercise, until their MSR is met. Where an executive director has met less than 50% of his or her MSR, the executive must retain 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired through the various share schemes; if an executive has met between 50% and 100% of their MSR, the executive must retain 25% of the net value. In the event that the executive director is still not compliant with their MSR at the end of the five-year period, the Committee will set out proposed remedial actions at that time.

In response to the new Code requirements, the Committee has established a formal post-cessation shareholding policy applicable to all executive directors. For UK executive directors, the policy is based on the full MSR continuing to apply for a period of two years. For US executive directors, the policy is based on 300% MSR applying for a period of one year. Executive directors will be required to sign a contract on leaving employment to ensure compliance with this policy.

Pension provision

The Committee recognises the desire to see pension provision for highly-compensated executives being brought in line with those available to the wider workforce. BAE Systems operates a variety of different pension arrangements across the UK workforce (as well as a range of different retirement income plans worldwide). The Company currently has a number of defined benefit (DB) plans which are closed to new entrants, with new hires being offered membership of a defined contribution (DC) pension scheme. Employer contribution rates for the different schemes range from 8% to approximately 50% salary. The level of employer contribution for UK employees based on a weighted average of active members across all schemes is approximately 17%.

Our current approved policy applying to any new externally appointed UK executive director is the membership of the Executive Pension Scheme Defined Contribution Retirement Plan (EPS DCRP) with an employer contribution rate of 19% of salary. The Defined Contribution Retirement Plan (DCRP) is available to all employees, with employer contributions set at 8% of salary for the wider workforce. Against this background, the Committee concluded that all new UK executive director appointments should be offered membership of the DCRP with the employer contribution rate set at 8% of salary to be consistent with the policy for new hires in the wider workforce in the UK. Consistent with this policy, the Group Finance Director designate, Brad Greve, who joined BAE Systems in September 2019, and will join the Board in April 2020, has been offered pension membership in the DCRP on this basis.

Our Chief Executive is a member of the EPS DCRP with employer contributions at 19%. With effect from 2020, the Chief Executive has voluntarily agreed for the annual value of his contributions to be fixed at the monetary value of his 2020 employer pension contribution of £186,200 per annum. Assuming average salary increases in the region of 2.5% per annum, fixing the monetary value at this level will align the employer contribution rate applicable to the Chief Executive to the weighted average employer rate of 17% over a period of around four years. The Committee will continue to monitor the matter of pension provision as part of a broader mix of total remuneration.

Concluding comments

The Remuneration Committee remains committed to its policy of paying for performance. We are proposing some modest changes to our Remuneration Policy to ensure that the incentive arrangements for executives are meaningful whilst simultaneously aligning them to the Company's strategic goals and to the interests of our shareholders. As I hope you can tell from the detail in the accompanying report, the Committee is actively engaged in monitoring performance and continuing to ensure that the level of challenge within our annual and long-term incentive plans remains appropriate. As always, we invite your comments and the opportunity to collaborate on the framework of incentive and reward.

On behalf of the Board
Paula Rosput Reynolds
Chairman of the Remuneration Committee

Summary of key decisions in 2019

- Determination of remuneration package applicable to newly-appointed Group Finance Director designate Brad Greve;
- approval of the retirement terms for outgoing Group Finance Director Peter Lynas in line with our approved Policy;
- salary of the Chief Executive is increased by 6.58% from 1 January 2020;
- approval of change in role, associated remuneration package and confirmation of retirement terms in line with our approved Policy for the Chief Executive Officer of BAE Systems, Inc. (Jerry DeMuro);
- determination of remuneration package applicable to Tom Arseneault on promotion to President and Chief Executive Officer of BAE Systems, Inc.;
- approval of remuneration packages for newly appointed Executive Committee members;
- long-term incentive awards of Performance Shares granted in Spring 2019, subject to the same performance conditions as applied in 2018, and Restricted Shares to US executive director only; and
- approval of the 2020 annual incentive metrics and weightings (no change from 2019).

The Remuneration Committee's year

Jan London, UK

Committee

- Assessed outturn of 2018 strategic objectives for executive directors and Executive Committee members.
- Agreed 2019 key strategic objectives for executive directors and Executive Committee members.

Feb London, UK

Committee

- Determined 2018 bonuses against performance for executive directors and Executive Committee members for payment in March 2019.
- Approved 2018 Group All-Employee Free Share Plans payments.
- Determined vesting outcome for 2016 Long-Term Incentive awards.
- Approved 2019 Long-Term Incentive awards and associated performance targets for executive directors and Executive Committee members.
- Considered an analysis of historical executive director remuneration compared to financial performance.
- Reviewed feedback from shareholder consultation on 2019 remuneration review.
- Approved 2018 Annual remuneration report.

May Farnborough, UK

Committee

- Reviewed feedback from shareholder consultation on 2019 remuneration review.
- Agreed the overall approach and timeline for the 2020 remuneration policy renewal.
- Approved the rules of the BAE Systems Cash Long-Term Incentive Plan 2019.

Jul London, UK

Committee

- Approved remuneration package for new or existing executive director and Executive Committee members.
- Reviewed a deep-dive in respect of 2020 remuneration policy renewal to support development of proposals.

Sep London, UK

Committee

- Reviewed progress against Executive Committee 2019 strategic objectives.
- Approved the proposed changes to the Remuneration Policy framework for 2020.
- Approved the vesting outcome of the 2016 Autumn Long-Term Incentive awards.
- Received remuneration analysis for individuals on Executive Committee succession plans.

Nov New Milton, UK

Committee

- Approved the approach to the development of the 2019 Annual remuneration report including response to the new reporting requirements.
- Reviewed level of executive directors' and Executive Committee members' shareholdings relative to their Minimum Shareholding Requirement.
- Reviewed dilution levels and share usage under Employee Share Plans.
- Approved operation of Group All-Employee Free Share Plans.
- Considered an overview of Group workforce remuneration and related policies and the alignment of incentives and rewards with culture.

Dec London, UK

Committee

- Considered the recent updates to institutional investor guidance.
- Considered the early shareholder consultation feedback and potential changes to the proposed Policy for 2020.
- Reviewed and set salaries and bonus opportunity levels for executive directors and Executive Committee members.
- Agreed the approach, structure and targets for the 2020 annual incentive plan.
- Approved the assessment of 2019 strategic objectives applicable to the Executive Committee.
- Reviewed the draft 2020 strategic objectives applicable to the Executive Committee.
- Approved remuneration package for new or existing executive directors and Executive Committee members.

Remuneration Committee timeline

January	February	May	July	September	November	December
Committee	Committee	Committee	Committee	Committee	Committee	Committee

Annual remuneration report at a glance

for the year ended 31 December 2019

Business performance and incentive outcomes in 2019

		2019 performance	2019 incentive outcome
Group underlying EPS[1]	AIP	50.4p	●
Group net debt[1]	AIP	£(807)m	●
Group order intake[1]	AIP	£17.8bn	●
Recordable Accident Rate (per 100,000 employees)[2]	AIP	470	●
Major injuries recorded	AIP	38	●
Average three-year diluted underlying EPS growth	LTI	>7%	●
Three-year TSR	LTI	10.6%	●

AIP Annual Incentive Plan
LTI Long-Term Incentive

● Below threshold
● Between threshold and target
● Between target and stretch

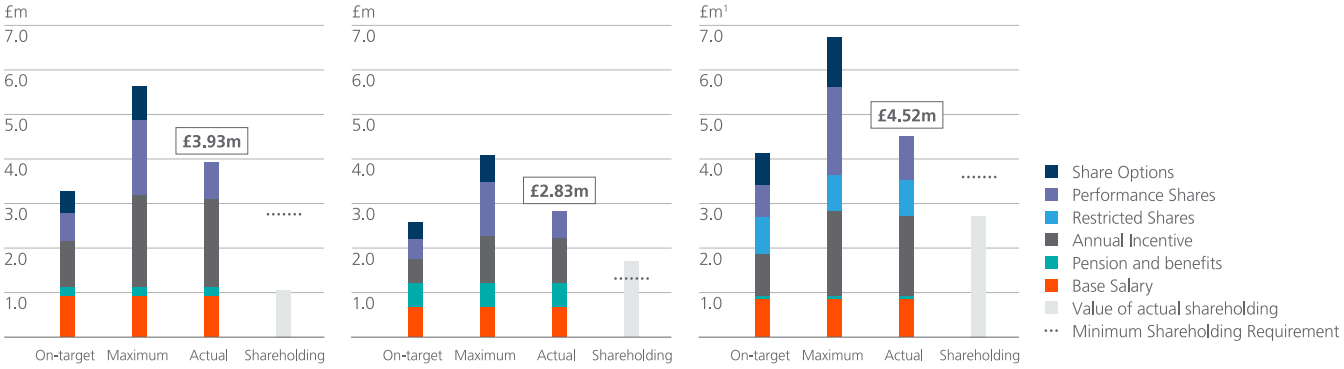
1. Adjusted to be on a like-for-like basis with the targets (see page 122).
2. Safety performance has been assigned accordingly with the US receiving a payout commensurate with a strong performance and those parts of the UK Maritime and Air businesses who did not meet target receiving zero. At Group level, a small part of the available award was made in recognition of strong performances in the US.

This resulted in the following incentive outcomes:

- 2019 annual bonus payouts for the executive directors were in the region of 95% of maximum; and
- Performance Shares (EPS) granted to the executive directors in March 2017 achieved stretch performance and will vest at 100%. Performance Shares (TSR) and Share Option awards granted at March 2017 to the executive directors did not meet their performance condition and will lapse. Performance Shares (TSR) and Share Option awards granted in September 2016 to the Chief Executive did not meet their performance condition and accordingly lapsed in September 2019.

Summary of executive directors' remuneration in 2019

The charts below show the 2019 actual remuneration achieved, as disclosed in the single total figure of remuneration on page 118, compared with the 2019 on-target and maximum opportunity. On-target remuneration assumes target vesting of incentives payable in respect of the performance period with year-end 2019, whilst maximum remuneration assumes maximum vesting of incentives payable. Actual remuneration for each of the executive directors was between target and stretch, reflecting the good business performance. Also included is the value of the actual shareholding for each executive director as at 31 December 2019 compared to their Minimum Shareholding Requirement.



Charles Woodburn
Chief Executive

Peter Lynas
Group Finance Director

Jerry DeMuro[2]
Chief Executive Officer of BAE Systems, Inc.

1. The figures for Jerry DeMuro have been converted from US dollars to sterling.
2. Long-term incentive figures in the charts above are based on the 2017 Performance Shares, Share Options and Restricted Shares awards. For Jerry DeMuro, the single total figure of remuneration on page 118 includes his 2019 Restricted Shares award as required by regulation.

Remuneration in the wider context

The Committee has responsibility for reviewing remuneration and related policies applicable to the wider workforce and the alignment of incentives and rewards with culture, ensuring this is taken into account when setting the policy for executive remuneration. As detailed on page 35 our objective is to create an inspiring and inclusive workplace for all our employees and that they are recognised and rewarded for their contribution. Within this context:

- a consistent remuneration philosophy and strategy is applicable to all employees across the Group;
- 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;
- we also encourage employees to become shareholders in BAE Systems and, in some markets, offer share schemes to support this;
- level of 2019 salary adjustment for the executive directors and Executive Committee was consistent with the average increase for employees across the Group;
- the ratio of Chief Executive pay to pay of global workforce of 52:1; and
- the mean pay difference between men and women across the UK workforce is 10.3% in favour of men.

Annual remuneration report at a glance

for the year ending 31 December 2020

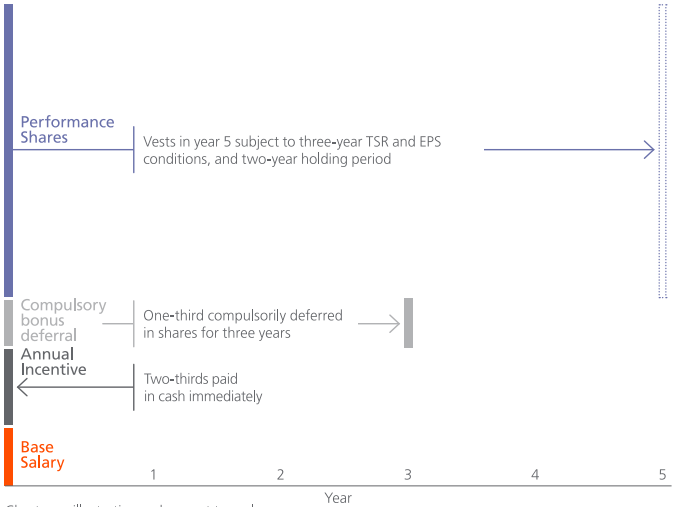
Summary of remuneration framework

The table below sets out the overall remuneration framework applicable to each of the executive directors under the current approved remuneration policy. The table shows Brad Greve who is to be appointed as Group Finance Director on 1 April 2020 and Tom Arseneault who is to be appointed as President and Chief Executive Officer of BAE Systems, Inc. on 1 April 2020.

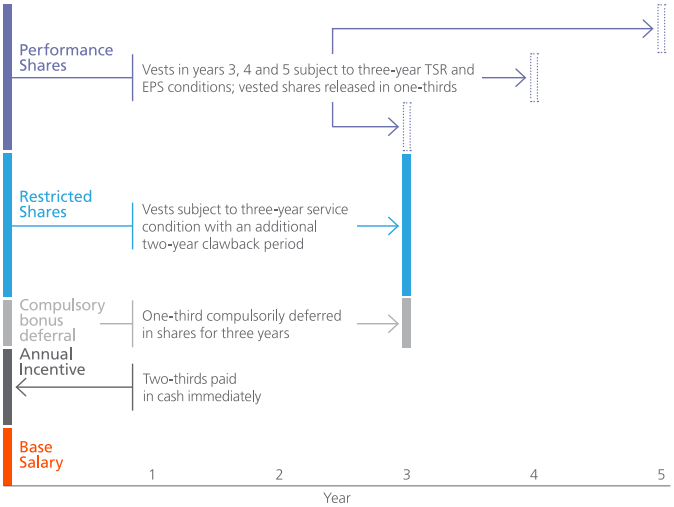
	Purpose and link to strategy		Charles Woodburn CEO	Brad Greve[1] GFD	Tom Arseneault[1] President and CEO Inc.
Base Salary (with effect from 1 January 2020)	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.		£980,000	£610,000	$980,000
Pension and benefits	Provide employment benefits and competitive post-retirement benefits to ensure overall package is market competitive.		Defined contribution	Defined contribution	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.	On-target/maximum opportunity (% salary)	112.5%/225%	80%/160%	112.5%/225%
		Performance condition	75% financial/25% 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)	370%	335%	298%
		Performance condition	50% relative TSR/ 50% three-year diluted underlying EPS growth		
Restricted Shares	Provide long-term reward through time-vesting awards principally in the Company's US market.	Grant (% salary)	n/a		150%
Minimum Shareholding Requirement	Provide long-term alignment with shareholder interests.	(% salary)	300%	200%	425%

1. Full details of executive director changes in 2020 are provided on pages 120 and 121. Tom Arseneault's salary is effective from his appointment to the Board on 1 April 2020.

Application of 2020 package for UK executive directors



Application of 2020 package for US executive director



Charts are illustrative and are not to scale.

2020 remuneration policy

The main revisions contained in the 2020 remuneration policy that is being put to shareholders for approval at the 2020 Annual General Meeting[1] (AGM) include:

- from 2021, safety and diversity and inclusion elements within non-financial annual incentive measure will be applied as a downward underpin if these are not achieved at high levels expected;
- from 2021, Performance Shares will be measured against a cash-generation measure and a metric reflecting strategic progress, in addition to existing EPS and relative TSR, all with equal weighting;
- new UK executive directors will be offered a pension provision of 8% of employer contributions into a defined contribution scheme, in line with the wider UK workforce;
- current CEO pension to be fixed in monetary terms at his 2020 employer pension contribution level;
- introduction of a five-year time period for achieving Minimum Shareholding Requirement (MSR) and confirmation of the consequences of not meeting it; and
- establishment of a formal post-cessation shareholding policy.

1. The full Directors' remuneration policy for approval by shareholders at the 2020 Annual General Meeting is set out on pages 131 to 145.

Annual remuneration report

for the year ended 31 December 2019

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2019 and will be proposed for an advisory vote by shareholders at the 2020 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.

Response to new remuneration reporting provisions in the 2018 UK Corporate Governance Code

In response to the new Code requirements, you will find the following detailed in our reporting:

115	Strategic rationale of our remuneration framework.
110	Appropriateness of our remuneration.
114	How the Committee has addressed the factors of clarity, simplicity, risk, predictability, proportionality and alignment to culture.
105	Operation of our policy.
116	Engagement with shareholders.
110	Engagement with our workforce.
105	Exercise of discretion.

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Statement of voting

Shareholder voting on the resolutions to approve the Annual remuneration report put to the 2019 AGM and the Directors' remuneration policy put to the 2017 AGM was as follows:

Annual remuneration report

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,346,572,322	98.37	38,914,627	1.63	2,385,486,949	53,611,945

Directors' remuneration policy

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,286,232,998	95.09	118,030,799	4.91	2,404,263,797	6,035,623

The Company's current remuneration policy approved at the 2017 AGM is available in the Investor Relations section of the Company's website: baesystems.com.

The Company's proposed remuneration policy for approval at the 2020 AGM is detailed on pages 131 to 145.

Appropriateness of remuneration and wider context

Our reward philosophy and approach

The Committee has responsibility for reviewing remuneration and related policies applicable to the wider workforce, ensuring that this is taken into account when setting the policy for executive remuneration. Our aim across the Group is to provide a reward package that is aligned to shareholders' interests, supports the achievement of the Company's in-year and strategic objectives, is competitive against the appropriate market and is consistent with our focus on performance and our values of Trusted, Innovative and Bold. This means:

- base salaries are set with reference to median of the relevant market competitive level;
- high performance and exceptional contribution are recognised through in-year incentives;
- packages for leadership roles have an increased emphasis on longer-term share-based reward;
- providing employees with competitive and affordable retirement benefits which reward long-term contribution and loyalty; and
- ensuring access to a competitive and cost-effective package of other benefits as part of our total reward offering.

As set out on page 114, the Committee considered a number of core principles in the renewal of our remuneration policy for executive directors, including how our reward policy and practice compares across the wider workforce. The table below illustrates this for the different groups of employees within BAE Systems.

	Executive directors	Executive Committee	Senior executives	Middle management	Wider workforce
Base salary	Base salary is set based on market pay approach recognising the individual's skill, knowledge, experience levels and contribution to role. Normally reviewed annually with increases typically in line with the wider workforce.				Base salary is either subject to negotiation with recognised trade unions and/or is set in line with market and/or performance.
Pension and benefits	Range of employment benefits and competitive post-retirement benefits in line with relevant home market.				
Short-term incentive	Annual incentive based 75% on financial performance of our KPIs and 25% on non-financial metrics of safety, diversity and inclusion and key strategic objectives. Compulsory deferral into shares for three years.	Annual incentive based 75% on financial performance of our KPIs and 25% on non-financial metrics of safety, diversity and inclusion and key strategic objectives. Compulsory deferral into shares for three years (except in the US).		Annual incentive based on business and individual performance.	In UK businesses, incentive typically based on business and/or individual performance.
Long-term incentive	Performance shares are subject to three-year performance conditions (and further holding requirements) designed to drive sustained company financial performance aligned to interests of shareholders. Restricted shares vest subject to service condition (applicable in US only).	Performance shares are subject to three-year performance conditions (and further holding requirements) designed to drive sustained company financial performance aligned to interests of shareholders. Share options are exercisable after three years. Restricted shares vest subject to three-year service condition (applicable in US only).		Eligible employees may participate in and receive free matching shares in our Company Share Incentive Plan (SIP) or international equivalent. Company rewards eligible employees with annual award of free shares, or cash equivalent, based on our Group financial performance.	

The Remuneration Committee regularly undertakes a deep-dive session to build its understanding of reward arrangements applicable to the wider workforce. The Committee is provided with visibility of remuneration practices in the different sectors/markets in which we operate and for the different populations within the wider workforce across the Company globally. These sessions have covered a range of topics including workforce demographics, the outcome of the reward review throughout the workforce, reward principles, job sizing, pay philosophy and pay ranges, annual and long-term incentive design, employee share plans and other employee benefits including pension and retirement schemes. During meetings, the Remuneration Committee is also periodically updated on wider employee matters such as the outcome of our UK gender pay analysis.

Whilst the Company does not currently directly engage with employees as part of the process of reviewing executive pay, formulating the Remuneration Policy and its alignment with wider company pay policy, the Company does receive insights from the broader employee population using an engagement survey. Further detail on engagement with employees is given on page 116.

Pay comparisons

Pay ratio of Chief Executive to global average employee

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 below provides the ratio of remuneration of the Chief Executive to the average employee of the Group since 2014.

As can be seen, the ratio has typically been around 50:1, with the ratio being higher in some years as a result of the partial vesting of Long-Term Incentive awards in those years. 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.

The ratio of remuneration of the Chief Executive to the average employee of the entire Group since 2014 was as follows:

	2014	2015	2016	2017[1]	2018	**2019**
Chief Executive's remuneration (£'000)[2]	3,519	2,929	3,463	3,365	2,416	**3,934**
Average employee remuneration (£'000)[3]	58	62	67	72	72	**76**
Ratio	60:1	47:1	52:1	47:1	33:1	**52:1**

1. Chief Executive's remuneration in 2017 includes a combination of the remuneration of Ian King and Charles Woodburn. As Charles Woodburn's overall remuneration was lower than Ian King's, the calculation for 2017 results in a downward movement in the pay ratio.
2. The Chief Executive's remuneration is calculated on the same basis as the single total figure of remuneration table.
3. 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 2018 figure excludes the Guaranteed Minimum Pension equalisation charge (see note 23 to the Group accounts).

Recognising the global nature of our workforce, we believe the above pay ratio measured against the average employee of the entire Group is the most appropriate for BAE Systems. We will therefore continue to provide the pay ratio on this basis.

Pay ratio of Chief Executive to UK average employee

As required by legislation, the table below provides the ratio of the Chief Executive to that of the median, 25th and 75th percentile total remuneration of full-time equivalent UK employees. We voluntarily disclosed the pay ratio on the required basis in 2018:

Year	Method	25th percentile pay ratio	Median pay ratio	75th percentile pay ratio
2019	**Option B**	**90:1**	**72:1**	**59:1**
2018	Option B	61:1	48:1	38:1

The reporting regulations offer three calculation approaches for determining the pay ratio – Options A, B and C. The table above has been calculated using the approach determined by Option B which is deemed the most appropriate methodology for BAE Systems. Recognising that BAE Systems has more than 30,000 UK employees, operating on different human resources and payroll systems, it is not feasible to adopt Option A. The calculations for the relevant representative employees were performed as at 31 December 2019.

To ensure Option B provides a sufficiently accurate representation of the UK workforce, we have performed sensitivity analysis around the three quartiles. Our approach has been to consider the total pay and benefits for a number of employees centred around each quartile. This allows any anomalies that may arise when calculating the total pay and benefits for the full financial year (such as if an employee left part way through the year) to be adjusted or excluded. By taking an average of the remaining figures, this provides a robust representation of each quartile.

The total full-time equivalent pay and benefits for the relevant employees has been calculated based on the amount paid or receivable in respect of the financial year. The calculations are on the same basis as required for the Chief Executive's remuneration for single total figure purposes. For pension-related benefits, employer pension costs have been estimated using the employer contribution rates applicable to the member's pension scheme. No other estimates or adjustments have been used in the calculation and no remuneration items have been omitted. A minority of employees in this calculation are employed on a part-time basis and therefore their remuneration has been annualised to reflect the full-time equivalent.

Our reward framework across the Group is based on a consistent set of principles, including managing reward by reference to external competitor benchmarks (see page 110). In the case of our Chief Executive, his total remuneration comprises a significant proportion in variable pay and therefore the single figure will vary considerably depending on the level of performance against the measures which drive the Annual and Long-Term Incentive Plans. The employees in the calculation would not typically participate in any long-term incentive plans and receive a significantly higher proportion of their remuneration in the form of fixed pay. The difference in ratio at the three quartiles is consistent with our market-based approach to reward, with the ratio increasing as the Chief Executive's remuneration is compared with that of more junior employees.

£	25th percentile	50th percentile	75th percentile
Total pay and benefits	43,873	54,833	66,964
Salary component	33,257	40,771	50,343

Relative to 2018, the pay ratio in 2019 has increased by approximately 50% this year at 25th, median and 75th percentiles. This is largely explained by an increase in annual bonus in respect of 2019 (95.6% of maximum in 2019 versus 65.5% in 2018), and partial vesting of long-term incentives in respect of performance ending in 2019 for the Chief Executive (compared with nil vesting in respect of 2018).

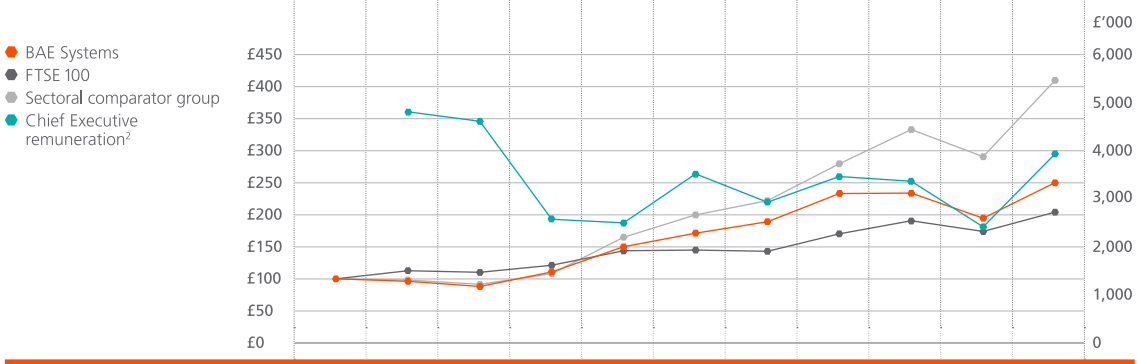
Total Shareholder Return (TSR) performance and Chief Executive pay

The graph below shows the value by 31 December 2019, on a TSR basis, of £100 invested in BAE Systems on 31 December 2009 compared with the value of £100 invested in the FTSE 100 index, including the effect of dividends. The graph additionally shows the remuneration of the Chief Executive, plotted on the secondary y-axis.

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. In addition, it forms 50% of the TSR performance measure for awards made from 2016 onwards. The equivalent data is shown for the sectoral comparator group which is of relevance to our international shareholder base.

The chart below demonstrates the strong long-term alignment of our Chief Executive pay and the returns to our shareholders. We achieved this through the Chief Executive receiving a high proportion of his remuneration in shares and with our performance conditions being based on measures which directly support the implementation of our strategy.

Value at 31 December 2019 of £100 investment at 31 December 2009



Change in Chief Executive's remuneration over ten years

	2009	2010	2011	2012	2013	2014	2015	2016	2017[1]	2018	**2019**
Chief Executive's single total figure (£'000)[3]											
Ian King		4,810	4,613	2,574	2,499	3,519	2,929	3,463	2,086	n/a	**n/a**
Charles Woodburn		–	–	–	–	–	–	–	1,279	2,416	**3,934**
		4,810	4,613	2,574	2,499	3,519	2,929	3,463	3,365	2,416	**3,934**
Bonus paid as a percentage of maximum											
Ian King		71.0%	68.6%	55.6%	53.4%	74.3%	72.4%	82.3%	75.9%	n/a	**n/a**
Charles Woodburn		–	–	–	–	–	–	–	75.8%	65.6%	**95.6%**
LTI as a percentage of maximum vesting[3]											
Ian King		57.6%	44.3%	nil	nil	16.8%	nil	nil	11.3%	n/a	**n/a**
Charles Woodburn		–	–	–	–	–	–	–	n/a	nil	**10.9%**

1. Ian King retired and stepped down as Chief Executive on 30 June 2017 and Charles Woodburn took over the position on 1 July 2017. Ian King's remuneration is shown from the start of the financial year until 30 June 2017. Charles Woodburn's remuneration is shown from 1 July 2017 to the end of that financial year.
2. Plotted on the secondary y-axis.
3. Total remuneration includes the value of share plans vesting that were granted prior to appointment as Chief Executive.

Annual percentage change in Chief Executive's remuneration

The percentage change from 2018 to 2019 in remuneration of the Chief Executive and average UK employee is shown in the table below. The level of salary adjustment for the Chief Executive was consistent with the average UK employee workforce. The increase in bonus in respect of 2019 performance is a reflection of the good financial performance in 2019.

	Change in Chief Executive's remuneration %	Change in average UK employee[1] remuneration %
Base salary	+2.5	+2.5
Taxable benefits	–9.1	+2.5
Bonus	+49.4	+18.4

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.

Gender pay

BAE Systems has published its annual gender pay gap report in line with the UK regulations. For 2019, the average (mean) gender pay gap for our UK workforce was 10.3% in favour of men (2018 9.0%), which is lower than the current UK national average of 17.3%. We have a gender pay gap because we employ around four times more men than women and a greater proportion of our senior leadership population is male. We rely on employing large numbers of employees with STEM qualifications and we, like other companies, face challenges recruiting females with these qualifications because there are significantly fewer women who study and work in these fields. We are working hard to improve our gender balance and to increase the numbers of women in senior executive positions and in engineering roles.

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 2018 and 2019.

Underlying EBITA[1]

(£m)

+9.8%



Returns to shareholders

(£m)

+3.0%



Total employee costs[2,3]

(£m)

+7.3%



Average headcount[4]

('000)

+3.9%



1. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items (see page 46).
2. The Saudi Arabia end of service benefit has been accounted for in accordance with IAS 19 with effect from 1 January 2019. 2018 includes £110m relating to the Guaranteed Minimum Pension equalisation charge (see note 23 to the Group accounts).
3. After excluding the impact of exchange translation, wages and salaries increased by approximately 3% per employee in 2019.
4. Excluding share of equity accounted investments.

Remuneration principles

The Committee established six core principles which underpin our approach to executive remuneration. The principles are aligned to BAE Systems' strategic objectives, taking account of shareholder expectations and the remuneration factors set out in Provision 40 of the 2018 UK Corporate Governance Code (the Code), as well as reflecting a stronger performance accountability across the enterprise. The Committee considered these principles in the renewal of our 2020 remuneration policy for executive directors, whilst being mindful of the alignment and fairness of remuneration with the wider workforce. The table below shows this close alignment between the Committee's core principles and the Code's factors, including how the Committee addresses each factor.

Factor within Provision 40	How the Committee has addressed the factor
Clarity	
Remuneration arrangements should be transparent and promote effective engagement with shareholders and the workforce.	In line with our commitment to full transparency and engagement with our shareholders on the topic of executive remuneration, the Remuneration Committee Chairman engages with our major shareholders to set out the changes planned for the following year. In a year of significant change, the Remuneration Committee Chairman will consult with our major shareholders to discuss and seek views on potential changes. The Company consults directly with the broader employee population on their remuneration through a variety of methods including WebEx, explanatory guides hosted on intranet, human resources or business-led briefings.
Simplicity	
Remuneration structures should avoid complexity and their rationale and operation should be easy to understand.	Clear direction of travel for changes to our reward framework in recent years has been to reduce the complexity of our long-term incentive arrangements as demonstrated by: – **2014:** Introduction of new single 'umbrella' LTI plan – simplicity and flexibility of design; and – **2018:** Simplification of construct by elimination of share options for executive directors.
Risk	
Remuneration arrangements should ensure reputational and other risks from excessive rewards, and behavioural risks that can arise from target-based incentive plans, are identified and mitigated.	Full range of design features exist within remuneration arrangements to take risks into account as follows: – malus and clawback mechanisms within AIP and LTIs; – Remuneration Committee application of reasonable discretion to override formulaic outcomes; and – safety objective within AIP focuses on recordable accident rate and major injuries recorded.
Predictability	
The range of possible values of rewards to individual directors and any other limits or discretions should be identified and explained at the time of approving the policy.	Our remuneration policy contains the following: – maximum award levels and vesting outcomes applicable to annual and long-term incentive arrangements; and – as set out above in Risk, the Committee has the ability to apply malus, clawback and reasonableness discretion where appropriate.
Proportionality	
The link between individual awards, the delivery of strategy and the long-term performance of the Company should be clear. Outcomes should not reward poor performance.	Performance conditions attached to annual and long-term incentive arrangements require a minimum level of performance to be achieved before any payout is made. As set out on page 115, there is a direct link between an individual's reward and their contribution to driving strategy and increasing company performance. No payment is made for poor performance. Any individual's performance that is below expectations is dealt with as part of our performance management process – any individual leaving due to performance issues would not be entitled to any incentive payments.
Alignment to culture	
Incentive schemes should drive behaviours consistent with company purpose, values and strategy.	As set out on page 115, there is a direct link between driving BAE Systems' strategy and an individual's reward. As shown opposite, the Committee has established six core principles which underpin the philosophy and approach to executive remuneration to ensure alignment to BAE Systems' strategic objectives.

Remuneration Committee core principles

Simplicity
Clarity and simplicity of design; ease of understanding by executives and external stakeholders.

Motivational
Plans are relevant and meaningful with clear line of sight between actions and reward outcomes; metrics and targets which drive superior performance and value for shareholders.

Aligned with shareholder interests
Close alignment of reward outcomes and shareholder experience; long-term share ownership and 'skin in the game' for executives.

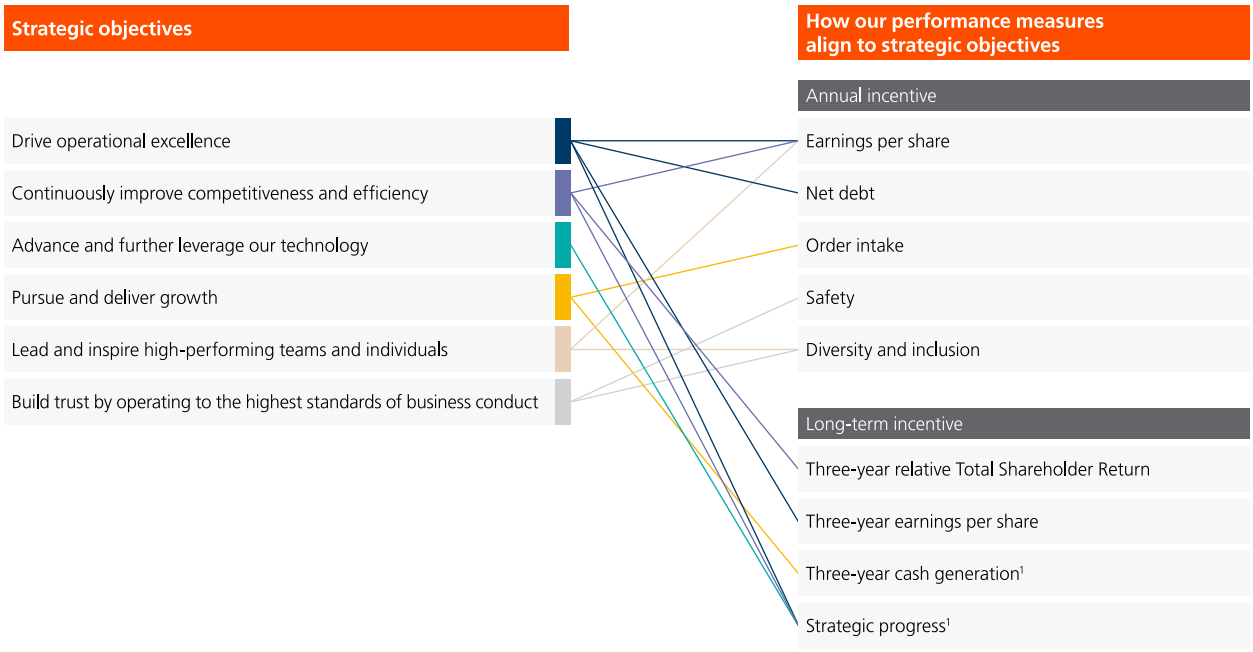
Globally competitive
Compensation opportunity aligned to relevant competitive employment market; enabling mobility across different businesses and geographies.

Acceptable to shareholders
Compliance with proxy bodies and corporate governance guidelines; continuing government, investor, media and public scrutiny of executive pay and fairness relative to wider workforce.

Flexibility/adaptability
Transparent and responsible application of discretion to override formulaic outcomes; ability to respond to special/ unforeseen circumstances during life of binding policy.

Strategic rationale for our directors' remuneration

As detailed on page 110, the Committee's aim across the Group is to provide a reward package that is aligned to shareholders' interests, supports the achievement of the Company's in-year and strategic objectives, is competitive against the appropriate market and is consistent with our focus on performance and our values of Trusted, Innovative and Bold. In the context of our executive directors and senior executive population, a significant proportion of their remuneration package is performance-related, and the performance conditions applying to incentive arrangements support the delivery of the Company's strategy. The chart below shows the alignment of our incentive measures with our strategic objectives.



The table below sets out how our executive directors' and senior executives' remuneration framework directly aligns to our strategy.

Element	Purpose and link to strategy
Base salary	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.
Pension and benefits	Provide employment benefits and competitive post-retirement benefits to ensure overall package is market competitive.
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.
Bonus deferral	Increases alignment with shareholder interests.
Performance shares	Direct financial measures of long-term earnings and cash generation[1] that drive our financial ambitions for the Company, and external strategic measures[1] including relative TSR performance, aligned to the interests of shareholders.
Restricted shares (US only)	Provide long-term reward through time-vesting awards principally in the Company's US market.
Share options (below executive director level)	Drive and reward delivery of sustained improvement in the Company's share price.
Shareholding requirements	Provide long-term alignment with shareholder interests.

1. Applies under the proposed 2020 Directors' remuneration policy.

Engagement with shareholders

In line with our commitment to full transparency and engagement with our shareholders on the topic of executive remuneration, the Remuneration Committee Chairman annually writes to our major shareholders and also Institutional Shareholder Services, the Investment Association and Glass Lewis, to set out the changes planned for the following year. In a year of significant change, such as this year with the renewal of our Remuneration Policy, the Remuneration Committee Chairman will additionally engage directly with our major shareholders to discuss and seek views on potential changes. The Remuneration Committee Chairman values direct engagement with our shareholders and makes herself available for such meetings throughout the year to hear their perspective on remuneration matters.

Engagement with shareholders in the formulation of the proposed 2020 Remuneration Policy is referenced in the Committee Chairman's report on page 102.

During 2018, BAE Systems conducted a Governance Investor event, aimed at encouraging greater transparency and awareness of our governance programmes. The event provided an opportunity for closer contact with non-executives, particularly the committee chairs. As part of this, the Remuneration Committee Chairman shared an overview of the Remuneration Committee including the key themes and areas for focus for the Committee looking forward. A similar event has been scheduled for March 2020.

Engagement with workforce

The skills, capabilities and commitment of our people are critical to ensuring the long-term sustainability of our business and delivering the innovation needed to solve our customers' complex challenges. Effective engagement enables our employees to contribute to improving business performance and helps us to create an environment in which everyone can fulfil their potential.

Recognising that our ways of working are critical to achieving our strategic priorities, we have increased our focus on assessing and rewarding both what our people achieve, and how they achieve it. During 2019, we introduced a set of Company Behaviours to define how we want to work together and with our stakeholders, encouraging attributes such as collaboration, innovation, creativity and adaptability that will underpin personal, team and organisational success. Together, our Company Behaviours and our shared strategic objectives give clarity on what is expected and how we can work together to deliver our strategy and achieve our potential.

We keep employees informed about what is happening across the business using a variety of media, including our intranet, email and employee app, through podcasts, newsletters, leadership blogs and trade union forums, and also through leadership briefings and team meetings where we seek to listen to employees' views and opinions. Employees are encouraged to share their views through our channels and employee surveys.

As shareholders through our all-employee share schemes, eligible employees are encouraged to vote and attend our Annual General Meeting (AGM). In addition to providing an update on our business performance, it also provides the opportunity for them in their capacity as shareholders to ask questions to our Chairman and other members of the Board.

Single total figure of remuneration

Single total figure of remuneration for the Chairman and non-executive directors

	Fees £'000		Benefits £'000		Other £'000		**Total £'000**		Total fixed remuneration £'000		Total variable remuneration £'000	
	2019	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018
Chairman												
Sir Roger Carr	**700**	700	–	–	–	–	**700**	700	**700**	700	–	–
Non-executive directors												
R Advaithi	**80**	80	**7**	9	**18**	23	**105**	112	**105**	112	–	–
Dame E P L Corley	**80**	80	**3**	2	**4**	9	**87**	91	**87**	91	–	–
H Green[1]	**68**	80	**2**	11	**18**	27	**88**	118	**88**	118	–	–
C M Grigg	**80**	80	**3**	4	**4**	9	**87**	93	**87**	93	–	–
S T Pearce[2]	**47**	n/a	**1**	n/a	**4**	n/a	**52**	n/a	**52**	n/a	–	n/a
N W Piasecki[2]	**47**	n/a	**11**	n/a	**13**	n/a	**71**	n/a	**71**	n/a	–	n/a
P Rosput Reynolds	**105**	105	**8**	9	**27**	27	**140**	141	**140**	141	–	–
N C Rose	**130**	130	**1**	1	**4**	9	**135**	140	**135**	140	–	–
I P Tyler	**105**	105	**2**	3	**5**	9	**112**	117	**112**	117	–	–

1. Retired from the Board on 7 November 2019.
2. Appointed to the Board on 1 June 2019.

● Fixed remuneration element
● Variable remuneration element

Chairman

Sir Roger Carr's fee was set at £700,000 per annum with effect from 1 February 2017 and has remained at that level following a review prior to the commencement of his third three-year term from 1 February 2020.

The Chairman's fee is set by the Remuneration Committee and will not be reviewed again for the remainder of his current three-year term.

Non-executive directors

The non-executive directors' fees are set by the Non-Executive Directors' Fees Committee which comprises Sir Roger Carr (Committee Chairman), Philip Bramwell (Group General Counsel), Jerry DeMuro and Charles Woodburn.

The fee structure on a per annum basis is set as follows: (i) Chairman, Audit Committee: £105,000; (ii) Chairman, Corporate Responsibility Committee: £105,000; (iii) Chairman, Remuneration Committee: £105,000; (iv) other non-executive directors: £80,000; and (v) additional fee for Senior Independent Director: £25,000. 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 non-executive fee structure was reviewed in January 2020 and was agreed that the fee of each individual non-executive director would increase by £5,000 per annum with effect from 1 April 2020 (with no change to the additional fee for the Senior Independent Director). This will be subject to periodic review.

The above table has been subject to audit.

Single total figure of remuneration for the executive directors

	Base salary £'000		Taxable benefits[1] £'000		Bonus[2] £'000		LTIP[3] £'000		Pension[4] £'000		Other[5] £'000		**Total £'000**		Total fixed remuneration £'000		Total variable remuneration £'000	
	2019	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018	**2019**	2018
C N Woodburn	**920**	897	**21**	23	**1,978**	1,324	**838**	–	**175**	171	**2**	1	**3,934**	2,416	**1,116**	1,091	**2,818**	1,325
P J Lynas	**658**	642	**19**	25	**1,006**	653	**612**	122	**535**	460	**1**	–	**2,831**	1,902	**1,212**	1,127	**1,619**	775
J DeMuro[6]	**849**	789	**49**	42	**1,805**	936	**985**	167	**13**	13	**1,317**	1,217	**5,018**	3,164	**911**	844	**4,107**	2,320

● Fixed remuneration element
● Variable remuneration element

The above table has been subject to audit.

1. The benefits received by Charles Woodburn include the provision of a car allowance and the private use of a chauffeur-driven car (2019 £21k; 2018 £23k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2019 £19k; 2018 £23k). The prior year figure for Peter Lynas also includes the final payment in respect of his second residence allowance (£2k). Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (2019 £2k; 2018 £2k); medical and dental benefits (2019 £13k; 2018 £13k); insured life and disability benefits (2019 £9k; 2018 £9k); and the private use of a company aircraft (2019 £25k; 2018 £18k).
2. Further detail on bonus payments is provided on page 122. One-third of the net bonus paid to 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 values in the 2019 column are calculated on the basis of the three-month average share price of £5.64 as at 31 December 2019 and relate to the vesting portion (100%), including shares deriving from notional reinvested dividends, of the 2017 LTIP PS^{EPS} granted to Charles Woodburn, Peter Lynas and Jerry DeMuro for which the performance period ended on 31 December 2019 (see page 124 for further detail).

   An estimate of the amount of 2017 LTIP award attributable to share price appreciation is set out below. As the 2017 LTIP grant price was higher than the 2019 year-end share price, this has resulted in a negative share price appreciation for the 2017 vested awards.

	2017 LTIP PS £	2017 LTIP RS £
C N Woodburn	–107,421	–
P J Lynas	–78,361	–
J DeMuro	–126,169	–104,272

   As required by regulation, the estimated vesting values for the awards shown in the 2018 column (which were calculated in the 2018 Annual Report on the basis of the three-month average share price of £5.17 as at 31 December 2018), have been adjusted to reflect the actual value on the vesting of the performance award in March 2019 based on the then share price of £4.62. The figures reported in the 2018 column in the 2018 Annual Report on the estimated basis were Peter Lynas: £145k; and Jerry DeMuro: £200k. The respective figures in the 2018 Total column have been recast accordingly. Note, as the exercise price was higher than the then share price, the value in respect of share options has been shown as zero.

4. The figures for 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 under review, net of inflation. These figures are also sensitive to salary increases and Consumer Prices Index (CPI) inflation as follows:
   - Salary increase: Pensionable salary is averaged over three years. The figures for Peter Lynas reflect his salary increase since 31 December 2018.
   - 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 2019 figures, the reference CPI inflation was 2.4%.

   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.

   Further detail on pensions is given on page 125.
5. This column includes (i) the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) of £698 for Charles Woodburn, and his Matching Shares under voluntary investment in the SIP; and (ii) for Jerry DeMuro, the value of the 2019 grant of Restricted Shares (£1,245k). This award formed part of Jerry DeMuro's 2019 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached. The balance of the 2019 figure (£72k) relates to the value of notional reinvested dividends in respect of his 2016 Restricted Share Plan award which vested in March 2019, the third anniversary of grant. The value of the related award was reported in the 2016 Remuneration report. His prior year figure relates to a similar Restricted Shares award in 2018 and the value of the notional reinvested dividends in respect of his 2015 Restricted Share Plan award. For Peter Lynas, the value of his 2019 Free Share award under the SIP was £698 (2018 £394).
6. Jerry DeMuro is paid in US dollars with the disclosed figures above being converted into sterling at the required exchange rate. The 2019 salary reflects his 2.5% salary increase and the exchange rate fluctuations experienced in 2019.

The value of existing LTIPs[1] delivered in 2019 to Ian King, a former director, totalled £152,538. There were no other payments to former directors in 2019.

1. Previously disclosed and subject to the attainment of performance conditions.

Implementation of our policy in the year ending 31 December 2020

For the purposes of the Companies Act 2006, the Directors' remuneration policy (the Policy) has been operating in practice since the date of its approval on 10 May 2017 at the 2017 AGM. The remuneration for 2020 will be implemented as follows:

- The salary of the Chief Executive is increased by 6.58% to £980,000 with effect from 1 January 2020.
- The salary of the retiring Group Finance Director remains at the 2019 level; that for his successor is detailed on page 120.
- The salary of the retiring Chief Executive Officer of BAE Systems, Inc. remains at the 2019 level; that for his successor is detailed on page 121.
- Annual and Long-Term Incentive opportunity levels are in line with 2017 approved Policy.
- Long-Term Incentive awards of Performance Shares only for UK executive directors, and Performance Shares and Restricted Shares for US executive director.
- The performance measures and weightings for 2020 for the Annual Incentive and Long-Term Incentives are set out on pages 134 and 136.
- 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 Company's proposed remuneration policy for approval at the 2020 AGM is detailed on pages 131 to 145 and discussed in the Remuneration Committee Chair's report commencing on page 102.

Executive director changes in 2020

Group Finance Director

As announced by the Company on 8 August 2019, the following arrangements will apply in relation to Peter Lynas when he retires as a director and ceases employment on 31 March 2020. The arrangements are in accordance with the Company's Remuneration Policy, approved by shareholders and the Rules of the Company's 2000 Pension Plan and Executive Pension Scheme outlined in the 2018 Annual Report:

Peter Lynas' retirement on 31 March 2020 will be at his Normal Retirement Date and accordingly:

- he will be entitled to receive his accrued pension benefit in accordance with the Rules of the BAE Systems 2000 Pension Plan and the BAE Systems Executive Pension Scheme;
- under the Rules of the BAE Systems Long-Term Incentive Plan, any unvested share awards will vest at the normal vesting date, subject to the relevant performance conditions and time pro-rating. Awards will be reduced pro-rata for time based on the period from grant date to 31 March 2020 (calculated on the basis of actual days employed). The applicable performance conditions will be tested at the end of the normal performance period. In the case of any such award which vests after 31 March 2020, the award remains exercisable for a period of six months from the day on which the award vests;
- bonus shares under the BAE Systems Deferred Bonus Plan will continue to be deferred and will be released on the normal release dates;
- any share awards held by him, which have vested on or before 31 March 2020 but have not been exercised at that date will lapse unless exercised in the six-month period from 31 March 2020 or, if earlier, the date on which such award normally lapses;
- following termination of employment, he will be subject to a reduced minimum shareholding requirement equivalent to 100% of salary for a period of two years from leaving employment;
- he will remain eligible to receive an annual incentive payment for 2019 in accordance with the Company's Remuneration Policy. Any bonus will be subject to compulsory deferral of one third of the net amount under the BAE Systems Deferred Bonus Plan in the normal way with the balance being paid at the normal bonus payment date in March 2020;
- he will be eligible for an annual incentive payment for 2020, determined by the Remuneration Committee, subject to an assessment of performance and pro-rated for three months of service during 2020. Any bonus will be paid at the normal bonus payment date following the end of the 2020 financial year and subject to compulsory deferral of one third of the net amount under the BAE Systems Deferred Bonus Plan in the normal way;
- he will continue to be covered by the Company's D&O insurance policy and his current director's indemnification arrangements will remain in place;
- he will continue to be bound by the terms of his service contract which continue to apply following cessation of employment including post-termination restrictive covenants and confidentiality provisions;
- his annual salary will remain at the current level until his retirement date;
- no payment in lieu of notice or other termination payment will be payable; and
- taxable benefits comprising the provision of a car allowance and the private use of a chauffeur-driven car will cease from 31 March 2020.

As also announced on 8 August 2019, the Company has appointed Brad Greve as Group Finance Director Designate to succeed Peter Lynas as Group Finance Director and join the BAE Systems plc Board on 1 April 2020. He joined BAE Systems and became a member of the Executive Committee in September 2019. His remuneration arrangements are in line with the Company's Remuneration Policy approved by shareholders:

- base salary of £610,000;
- eligible for participation in the BAE Systems plc Annual Incentive and Long-Term Incentive Plan;
- Minimum Shareholding Requirement of 200% of base salary; and
- pension – Company contribution of up to 8% of reference salary.

In accordance with the Remuneration Policy, the Company has bought out certain incentives previously awarded by his previous employer and forfeited as a consequence of joining BAE Systems at a level consistent with the fair value at the time of recruitment in the form of a one-off payment for forfeited earnings as follows:

- £210,000 cash payment to be paid within 30 days of commencing employment. 50% of the net amount must be used to purchase BAE Systems plc shares within 120 days following payment.

Chief Executive Officer, BAE Systems, Inc.

As announced on 17 December 2019 Jerry DeMuro will retire from the Company on 31 December 2020. He will step down from the BAE Systems plc Board and from his role as Chief Executive Officer of BAE Systems, Inc. on 31 March 2020 and undertake the role of Executive Vice President until the end of the year, remaining on the BAE Systems, Inc. Board. In this capacity he will have responsibility for the delivery of a number of strategic assignments across BAE Systems' US and other businesses, including a governance review of global shipbuilding.

The following arrangements will apply in relation to Jerry DeMuro when he retires as a director of BAE Systems plc on 31 March 2020 and ceases employment on 31 December 2020. The arrangements are in accordance with the Company's Remuneration Policy, approved by shareholders and contained in the 2018 Annual Report:

For retirement benefit and share plan purposes, Jerry DeMuro will separate from the Company with the Company's consent on 31 December 2020 and:

- he will be entitled to receive his accrued retirement savings plan benefit in accordance with the Rules of the BAE Systems, Inc. 401(k) Plan;
- under the Rules of the BAE Systems Long-Term Incentive Plan, any unvested share awards will, subject to the discretion of the Remuneration Committee, vest on 31 December 2020 or, if later, as soon as practicable after the first opportunity when any relevant performance conditions can be determined, and subject to time pro-rating. Awards will be reduced pro-rata for time based on the period from grant date to 31 December 2020 (calculated on the basis of actual days employed). The applicable performance conditions will be tested at the end of the normal performance period;
- bonus shares under the BAE Systems Deferred Bonus Plan will continue to be deferred and will be released on the normal release dates;
- any share awards held by him, which have vested on or before 31 December 2020 but have not been exercised at that date will lapse unless exercised in the six-month period from 31 December 2020 or, if earlier, the date on which such award normally lapses;
- following termination of employment, he will be subject to a minimum shareholding requirement equivalent to 300% of salary for a period of one year from leaving employment;
- he will remain eligible to receive an annual incentive payment for 2019 in accordance with the Company's Remuneration Policy. Any bonus will be subject to compulsory deferral of one third of the net amount under the BAE Systems Deferred Bonus Plan in the normal way with the balance being paid at the normal bonus payment date in March 2020;
- he will be eligible for an annual incentive payment for 2020, determined by the Remuneration Committee, subject to an assessment of performance and pro-rated for three months of service during 2020. Any bonus will be paid at the normal bonus payment date following the end of the 2020 financial year and subject to compulsory deferral of one third of the net amount under the BAE Systems Deferred Bonus Plan in the normal way;
- for the period from 1 April 2020 in his future role as Executive Vice President, his annual salary will remain at the current level until his retirement date of 31 December 2020. In addition, he will remain eligible to receive an on-target bonus payment equivalent to 112.5% of base salary, pro-rata for the actual number of months worked;
- he will not be eligible to receive any future awards under the Company's Long-Term Incentive Plan;
- he will continue to be covered by the Company's D&O insurance policy and his current director's indemnification arrangements will remain in place;
- he will continue to be bound by the terms of his service contract which continue to apply following cessation of employment including post-termination restrictive covenants and confidentiality provisions;
- no payment in lieu of notice or other termination payment will be payable; and
- benefits comprising the use of a chauffeur-driven car, medical and dental benefits and insured life and disability benefits will cease from 31 December 2020.

Tom Arseneault will succeed Jerry DeMuro as President and Chief Executive Officer of BAE Systems, Inc. and will join the BAE Systems plc Board on 1 April 2020. Tom Arseneault has been President and Chief Operating Officer of BAE Systems, Inc. since May 2019 and will continue as a member of the BAE Systems, Inc. Board and the BAE Systems plc Executive Committee. His Remuneration arrangements are in line with the Company's Remuneration Policy approved by shareholders:

- base salary of $980,000. (Note: Tom Arseneault has been appointed with a base salary which is approximately 10% below that of his predecessor. Consideration will be given to close this differential in the first two years, dependent on performance in the new role.);
- eligible for participation in the BAE Systems plc Annual Incentive and Long-Term Incentive Plan; and
- Minimum Shareholding Requirement of 425% of base salary.

Annual bonus

Annual bonuses for the 2019 year are paid in March 2020. Annual bonus is made up of financial metrics, safety, diversity and inclusion, and personal objectives, designed to support the achievement of certain strategic outcomes necessary for the long-term sustainability of the business. The breakdown of bonus measures, achievement and payout 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.

Charles Woodburn Chief Executive

Measures		Weight (as a percentage of target)	Actual performance against targets set	Threshold for 2019	Target for 2019	Stretch for 2019	Actual performance[1]	Percentage of maximum opportunity
Financial	Group underlying EPS	45.0		43.0p	44.4p	45.5p	50.4p	100.0%
	Group net debt	22.5		£(1,798)m	£(1,522)m	£(1,082)m	£(807)m	100.0%
	Group order intake	7.5		n/a	£15.6bn	£17.5bn	£17.8bn	100.0%
Personal	Safety[2]	3.0		See note 2 below				25.0%
	Diversity and inclusion[2]	2.0		See note 2 below				100.0%
	Key strategic objectives	20.0		See Key strategic objectives section on page 123				89.5%
				Total bonus (as a percentage of maximum)				**95.6%**

Peter Lynas Group Finance Director

Measures		Weight (as a percentage of target)	Actual performance against targets set	Threshold for 2019	Target for 2019	Stretch for 2019	Actual performance[1]	Percentage of maximum opportunity
Financial	Group underlying EPS	45.0		43.0p	44.4p	45.5p	50.4p	100.0%
	Group net debt	22.5		£(1,798)m	£(1,522)m	£(1,082)m	£(807)m	100.0%
	Group order intake	7.5		n/a	£15.6bn	£17.5bn	£17.8bn	100.0%
Personal	Safety[2]	3.0		See note 2 below				25.0%
	Diversity and inclusion[2]	2.0		See note 2 below				100.0%
	Key strategic objectives	20.0		See Key strategic objectives section on page 123				89.5%
				Total bonus (as a percentage of maximum)				**95.6%**

Jerry DeMuro Chief Executive Officer of BAE Systems, Inc.

Measures		Weight (as a percentage of target)	Actual performance against targets set	Threshold for 2019	Target for 2019	Stretch for 2019	Actual performance[1]	Percentage of maximum opportunity
Financial	Group underlying EPS	15.0		43.0p	44.4p	45.5p	50.4p	100.0%
	Group net debt	7.5		£(1,798)m	£(1,522)m	£(1,082)m	£(807)m	100.0%
	Group order intake	2.5		n/a	£15.6bn	£17.5bn	£17.8bn	100.0%
	BAE Systems, Inc. underlying EBITA	30.0		$1,283.2m	$1,329.8m	$1,353.2m	$1,351.5m	96.4%
	BAE Systems, Inc. debt	15.0		$2,771m	$2,880m	$3,029m	$3,104m	86.3%
	BAE Systems, Inc. order intake	5.0		n/a	$11.5bn	$12.6bn	$13.4bn	100.0%
Personal	Safety[2]	3.0		See note 2 below				100.0%
	Diversity and inclusion[2]	2.0		See note 2 below				100.0%
	Key strategic objectives	20.0		See Key strategic objectives section on page 123				90.0%
				Total bonus (as a percentage of maximum)				**94.8%**

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 and diversity and inclusion elements of the bonus was determined by the Corporate Responsibility Committee (whose composition is stated on page 95). In respect of safety, whilst a reduction in the overall significant risk rating and improvements in behavioural safety were achieved across all parts of the Group, the target level of performance was not achieved in respect of key safety indicators, including expected level of improvement in recordable accidents, as denoted by the amber performance rating above. In relation to diversity and inclusion, the Company met stretch targets in respect of the increased representation of women at senior level, and progress towards the creation of an inclusive culture and workplace.

Key strategic objectives

Achievement against key strategic objectives represents 20% of the annual bonus opportunity applicable to each of the executive directors. These objectives relate to the delivery of the Group's strategic objectives and demonstration of leadership behaviours. Executive directors and Executive Committee members are assigned primary responsibility for, or required to support, a set of shared common strategic objectives. The objectives are both technical and organisational, grouped under the three key strategic priorities of drive operational excellence, improve competitiveness and efficiency and advance our technology. To support these priorities, there are six shared strategic objectives.

Key achievements in the year included:

Charles Woodburn Chief Executive	**Peter Lynas** Group Finance Director	**Jerry DeMuro** Chief Executive Officer of BAE Systems, Inc.
Drive operational excellence **Key successes in 2019** – Offshore Patrol Vessels and M109A7 programmes stabilised. HMS Prince of Wales delivered and commissioned on schedule. Steady progress made in addressing operational challenges in the US combat vehicles business.		
– Delivered net improved project performance margins. – Implemented a framework for Quality measurement across the Group. – Achieved improved Group supplier delivery quality metric. – Improved performance against cost and schedule requirements for major programmes.	– Delivered net improved project performance margins. – Plan targets exceeded, including agreements reached in respect of overseas tax matters. – Shared Services service level agreements met or exceeded.	– Delivered net improved programme margins. – Implemented a framework for Quality measurement within BAE Systems, Inc. – Achieved improved Group supplier delivery quality metric. – Improved performance against cost and schedule requirements for major programmes.
Continuously improve competitiveness and efficiency **Key successes in 2019** – Process improvements and robotic welding machines installed in US Combat Vehicles. First destroyer tandem docking in San Diego. Continued good progress against procurement transformation objectives.		
– Exceeded Group supply chain savings targets. – Reduced general and administration costs. – Improved customer satisfaction through greater transparency and project adherence.	– Exceeded Group supply chain savings targets. – Reduced general and administration costs.	– Exceeded BAE Systems, Inc. supply chain savings targets. – Reduced general and administration costs at BAE Systems, Inc. – Improved customer satisfaction scores.
Advance and further leverage our technology **Key successes in 2019** – Increased year-on-year self-funded R&D spend by 7%. Good progress made towards securing next-generation air combat capability through Team Tempest. Completed the Riptide and Prismatic technology-driven acquisitions.		
– Progress on Group-wide technology plans. – Technology advanced in key projects such as Tempest and Prismatic. – R&D spend increased.	– Provided financial support, financing plan and investor communications for successful bid in two acquisitions which expand capabilities.	– Progress against integrated technology plans; increased engagement with DARPA. – Highly active year in respect of R&D spend; successful bidder for two acquisitions which expand capabilities in Electronic Systems. – Increased use of automation across manufacturing and device delivery.
Pursue and deliver growth **Key successes in 2019** – US electronics business finished the year with a record order backlog. Contract awards received by Combat Vehicles further underpinned future growth in the Platforms & Services (US) business.		
– Order taken for the Canadian Surface Combatant programme, plus US orders (see adjacent column).	– Continued improvement in cost management and data to support successful bids, ongoing management of programmes and cash generation.	– Key successes in tenders and orders including AMPV LRIP, M109A7 full rate production, F-35 EW sustainment, Bradley A4 production line, I&S pipeline.
Lead and inspire high-performance teams and individuals (see note 2 on page 122 as separately assessed within diversity and inclusion target) **Key successes in 2019** – Management strengthened with a blend of internal promotions and external hires.		
– Group-wide succession planning and talent management under way. – Key executive leadership changes implemented.	– Finance and related function succession planning and talent management under way. – Successful induction of new Finance leadership.	– Improved succession planning and talent management through 'Accelerating our Talent' initiative. – Reduced attrition of under-represented groups.
Build trust by operating to the highest standards of business conduct **Key successes in 2019** – Special Security Agreement for BAE Systems, Inc. extension agreed with the US government.		
– Reduced overall significant Group risk rating by successful extension of SSA agreement, and maintaining IT security.	– Continued high level of internal and external audit results and strong financial controls. – Continued transparency in investor relations and positive feedback from annual investor survey.	– Reduced overall significant Group risk rating by successful extension of SSA agreement. – Received superior ratings for BAE Systems, Inc. system security plan.
Achievements were offset by need to drive further improvements in safety culture and organisation capabilities as to pace and agility.	Overall achievements were offset by the pace of progress in automation processes.	Achievements were offset by ongoing challenges in programme performance of certain legacy contracts and safety outcomes.
Payout (% of maximum): 89.5%	**Payout (% of maximum): 89.5%**	**Payout (% of maximum): 90%**

Long-Term Incentive Plan (LTIP) performance

Annual average diluted underlying EPS growth

Outperformance of performance conditions ending on 31 December 2019	Threshold	Maximum	Actual	Percentage of maximum achieved
2019 EPS requirement	43.7p	48.5p	50.5p	
Annual average EPS growth	3%	7%	>7%	100%

Relative TSR against comparator groups

Outperformance of performance conditions ending on 31 December 2019	Threshold	Maximum	Actual	Percentage of maximum achieved
TSR against sectoral comparator group	52.8%	69.2%	10.6%	0%
TSR against FTSE 100 comparator group	14.6%	55.3%	10.6%	0%
Overall vesting against TSR				0%

2017 Performance Shares (LTIP PS)

- Performance conditions: half on relative TSR against two comparator groups (with equal weighting), half on EPS growth of 3% to 7% per annum. The TSR three-year performance period ended on 31 December 2019 and the threshold performance was not met, thus the TSR portion of the award will lapse.
- With respect to the 2017 LTIP PS^{EPS} award, the related performance period also ended on 31 December 2019. As set out earlier in the annual report, the 2019 fully diluted underlying EPS is 45.5p. This figure excludes the one-off tax benefit of 5.0p. The Committee exercised its discretion and agreed that the final vesting outturn should reflect the 2019 fully diluted underlying EPS result including the tax benefit. The Committee's reasoning was as follows. First, the tax agreement was achieved as a result of long-term executive engagement with authorities and counter-parties and would not have been achieved without those efforts. Second, over the years, management prudently provided for the possibility of an adverse resolution, thereby reducing earnings and earnings growth in prior performance periods in which long-term performance was measured. Third, the resolution of the matter takes away a significant financial uncertainty and will improve the Company's future earnings potential. Fourth, this benefit comes in addition to an otherwise excellent year of performance where management has delivered superior results overall. The Committee was therefore satisfied that the performance condition was fully met and that it was appropriate for vesting of 100% of the EPS portion.

2017 Share Options (LTIP SO)

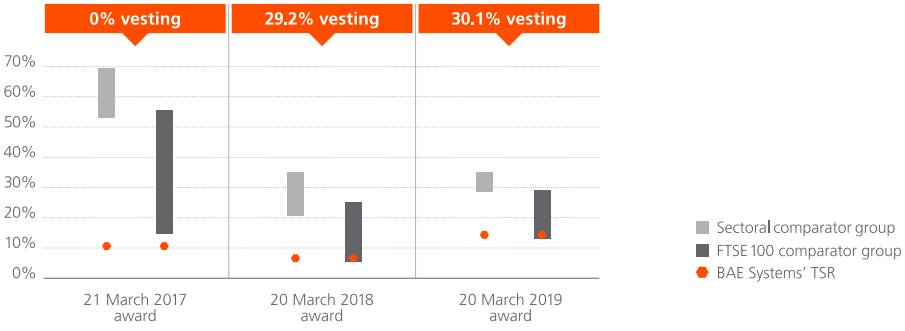
- Performance condition: relative TSR against two comparator groups (with equal weighting). The TSR three-year performance period ended on 31 December 2019 and resulted in nil vesting.

In respect of the 2016 LTIP PS^{TSR} and LTIP SO awards made to Charles Woodburn in September 2016, the performance period ended on 30 June 2019. The TSR performance condition was not met and thus this portion of the award lapsed. The EPS portion of his 2016 LTIP PS, for which the performance period ended on 31 December 2018, lapsed as the related performance condition was not met.

A summary of TSR performance to 31 December 2019 on outstanding TSR-related LTIP awards is illustrated in the chart below. The vesting percentage for the 21 March 2017 award is the actual vesting outturn referred to above.

The grey boxes show the range of TSR required for 25% vesting to full vesting in respect of the sectoral international defence and FTSE 100 comparator groups, as appropriate, and the orange hexagons 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 2019



Pension entitlements

Total pension entitlements

Director	Age	Normal retirement age	Accrued benefit at 1 January 2019[1,2] £ per annum	Accrued benefit at 31 December 2019[1,2] £ per annum	Figures included in the remuneration table on page 118: Added pension value received in the year from defined benefit scheme[2] £	Added pension value received in the year from defined contribution scheme £	Total £
Charles Woodburn	48	65	27,037	43,809	n/a	–	–
Peter Lynas	61	62	319,969	357,303	535,336	n/a	535,336
Jerry DeMuro	64	65	169,031	226,737	n/a	12,875	12,875

1. Accrued benefit for Charles Woodburn is the total value of his defined contribution account, including employee contributions and investment returns. 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.
2. The figure includes both funded and unfunded defined benefit arrangements for Peter Lynas. Accrued benefit for Peter Lynas is annual pension payable on retirement prior to any reduction for early payment or exchanging pension for cash. In addition, a longevity adjustment factor is applied to pension accrued after 5 April 2006 to mitigate against life expectancy changes. The 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.

The above table has been subject to audit.

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 and a 19% salary supplement is paid in lieu of the Company contributions.

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 (2020 $19,500; 2019 $19,000). In 2019, the company paid contributions of $17,050 into this arrangement.

Peter Lynas is a member of the BAE Systems Executive Pension Scheme (ExPS) and the BAE Systems Pension Scheme – 2000 Plan Benefits (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 for ExPS and age 65 for 2000 Plan 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. 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. Peter Lynas has 34 years and two months' service 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. Peter Lynas was given the choice to remain in the current arrangement and pay the increased tax or to take an unfunded promise; he 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, Peter Lynas' total pension is the sum of his 2000 Plan benefits plus the top-up from the ExPS, part of which is provided through the unfunded promise referred to above.

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
Charles Woodburn									
LTIP PS[TSR]	Performance Shares/nil cost option	20.03.19	350,737	185% of salary	1,701,074	nil	Three years to 31.12.21	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	20.03.19	350,737	185% of salary	1,701,074	nil	Three years to 31.12.21	EPS	25%
Peter Lynas									
LTIP PS[TSR]	Performance Shares/nil cost option	20.03.19	227,144	167.5% of salary	1,101,648	nil	Three years to 31.12.21	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	20.03.19	227,144	167.5% of salary	1,101,648	nil	Three years to 31.12.21	EPS	25%
Jerry DeMuro									
LTIP PS[TSR]	Performance Shares	20.03.19	254,932	149% of salary	1,236,420	n/a	Three years to 31.12.21	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares	20.03.19	254,932	149% of salary	1,236,420	n/a	Three years to 31.12.21	EPS	25%
LTIP RS	Retention	20.03.19	256,643	150% of salary	1,244,719	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.

Key: LTIP – Long-Term Incentive Plan. PS – Performance Shares. RS – Restricted Shares.

Note: Performance Shares and Restricted Shares – Shares under award attract notional reinvested 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 conditional share awards (rather than share options) and are deliverable on the third, fourth and fifth anniversary of grant, subject to attainment of the performance condition. For the UK executive directors, shares vest on the fifth anniversary of grant.

The table above has been subject to audit.

Description of share plans and summary of performance conditions

Long-term incentives operate under the BAE Systems Long-Term Incentive Plan (LTIP) approved by shareholders at the 2014 AGM. The three main vehicles in use are Performance Shares, Share Options and Restricted Shares.

LTIP Performance Shares

Up to 2017, shares under award vest after satisfaction of the three-year performance condition. Awards that vest are capable of exercise in three equal tranches on a phased basis from the third, fourth and fifth anniversary of grant. Any unexercised awards will lapse on the seventh anniversary of grant. From 2018, awards to UK executive directors remain subject to the three-year performance period but will not vest until the fifth anniversary of grant. They will be exercisable until the seventh 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. Shares under award attract notional reinvested dividends prior to tranche vesting.

Awards are weighted 50% on the EPS performance condition and 50% on the TSR performance condition as set out below. The TSR sectoral comparator group is shown below.

Plan	Performance condition
LTIP PS^{EPS}	Rate of average annual diluted underlying 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.
LTIP PS^{TSR}	The proportion of the award capable of exercise is determined by: (i) 50% of the TSR measure is on the current sectoral comparator group of other international defence companies and 50% is 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 less than median TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if the Company's TSR 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. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments.

The TSR sectoral comparator group for awards from 2020 comprises:		
General Dynamics	Lockheed Martin	SAIC
L3 Harris Technologies[2]	Meggitt	Thales
Leidos	Northrop Grumman	United Technologies
Leonardo	Raytheon	

2. Merger between Harris Corporation and L3 Technologies.

The TSR sectoral comparator group for awards from 2016–2019 comprises:		
Cobham	Leonardo	SAIC
General Dynamics	Lockheed Martin	Thales
Harris Corporation	Meggitt	United Technologies
L3 Technologies	Northrop Grumman	
Leidos	Raytheon	

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. Awards are subject to a further two-year clawback period after the initial three-year vesting period. From 2018 executive directors no longer receive share option awards.

Plan	Performance condition
LTIP SO	50% of the TSR measure is on the current sectoral comparator group of other international defence companies and 50% is 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 less than median TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if the Company's TSR is in the top quintile and vesting on a straight-line basis between these two parameters.

LTIP Restricted Shares

Restricted Shares are not subject to a performance condition as they are 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 notional reinvested dividends prior to vesting. Awards made to the US executive director 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 (including the portion of net annual bonus deferred compulsorily into BAE Systems shares) and his/her spouse count towards the MSR. Any case of non-compliance would be dealt with by the Committee.

The MSR does not currently apply after the individual has ceased to be a director; however, the Committee has agreed specific arrangements for post-cessation shareholding levels for Peter Lynas and Jerry DeMuro. On his retirement, Peter Lynas will be subject to a reduced MSR of 100% of salary for a period of two years. Following termination of employment, Jerry DeMuro will be subject to a MSR of 300% of salary for a period of one year. Both Peter's and Jerry's shareholding as shown below are in excess of this requirement. The Committee's proposed remuneration policy for approval at the 2020 AGM introduces a five-year time period in which to achieve MSR and a post-cessation shareholding requirement applicable to executive directors. Details are set out on page 139.

The following table sets out MSR Initial Value and Subsequent Value and actuals as at 31 December 2019:

	Initial Value	Subsequent Value	Actual
Charles Woodburn	150%	300%	115%
Peter Lynas	100%	200%	261%
Jerry DeMuro	212.5%	425%	322%

The actual MSR figures in the table are provided as at 31 December 2019, based on the year-end share price of £5.648.

Charles Woodburn joined the Board in 2016 and has been gradually building up his shareholding. The higher MSR values applicable to Jerry DeMuro (which were increased at the beginning of 2018) recognise the higher LTI opportunity and broader US market practice.

There are MSR requirements in place for all of the employee population who receive LTIPs.

There are no shareholding requirements for the Chairman or the non-executive directors.

Share interests as at 31 December 2019 (or on ceasing to be a director of the Company)

The interests of the directors who served during the year ended 31 December 2019 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 conditions	Share awards without performance conditions	Share options with performance conditions	Share options with performance conditions, vested but unexercised	Total scheme interests
Sir Roger Carr	126,093	–	–	–	–	–
R Advaithi	–	–	–	–	–	–
Dame E P L Corley	19,000	–	–	–	–	–
J DeMuro	481,802	1,254,627	581,229	503,106	102,004	2,440,966
H Green[1]	–	–	–	–	–	–
C M Grigg	24,555	–	–	–	–	–
P J Lynas	303,925	–	–	1,320,873	64,615	1,385,488
S T Pearce[2]	–	–	–	–	–	–
N W Piasecki[2]	–	–	–	–	–	–
P Rosput Reynolds	25,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–
C N Woodburn	188,401	–	–	1,884,409	–	1,884,409

1. Retired from the Board on 7 November 2019.
2. Appointed to the Board on 1 June 2019.

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 2019 are given on page 129 together with details of nil-cost options exercised in 2019.

Performance Shares granted under the LTIP are classified as share awards with performance conditions for the US executive director and as nil-cost options with performance conditions for the UK executive directors.

Since 31 December 2019, Charles Woodburn has acquired an additional 72 shares under the Partnership and Matching shares elements of the Share Incentive Plan so that his beneficial shareholding at the date of this report stood at 188,473.

There have been no changes in the interests of the remaining directors in the shares of BAE Systems plc between 31 December 2019 and the date of this report.

Breakdown of scheme interests: Options and awards held as at 31 December 2019

Charles Woodburn

	31 December 2019	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS^{TSR}	**132,897**[1]	21.03.17	nil	21.03.20
LTIP PS^{EPS}	**132,897**[2]	21.03.17	nil	21.03.20
LTIP PS^{TSR}	**285,227**[3]	20.03.18	nil	20.03.23
LTIP PS^{EPS}	**285,227**[3]	20.03.18	nil	20.03.23
LTIP PS^{TSR}	**350,737**[3]	20.03.19	nil	20.03.24
LTIP PS^{EPS}	**350,737**[3]	20.03.19	nil	20.03.24
	1,537,722			
LTIP SO	**346,687**[1]	21.03.17	6.49	21.03.20

Peter Lynas

	31 December 2019	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS^{EPS}	**17,255**[2]	25.03.15	nil	25.03.20
LTIP PS^{TSR}	**15,436**[2]	23.03.16	nil	23.03.20
LTIP PS^{TSR}	**96,944**[1]	21.03.17	nil	21.03.20
LTIP PS^{EPS}	**96,945**[2]	21.03.17	nil	21.03.20
LTIP PS^{TSR}	**184,731**[3]	20.03.18	nil	20.03.23
LTIP PS^{EPS}	**184,731**[3]	20.03.18	nil	20.03.23
LTIP PS^{TSR}	**227,144**[3]	20.03.19	nil	20.03.24
LTIP PS^{EPS}	**227,144**[3]	20.03.19	nil	20.03.24
	1,050,330			
LTIP SO	**64,615**[2]	23.03.16	4.99	23.03.19
LTIP SO	**270,543**[1]	21.03.17	6.49	21.03.20
	335,158			

Jerry DeMuro

	31 December 2019	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS^{EPS}	**22,922**[2]	25.03.15	n/a	25.03.20
LTIP PS^{TSR}	**21,098**[2]	23.03.16	n/a	23.03.20
LTIP PS^{TSR}	**156,092**[1]	21.03.17	n/a	21.03.20
LTIP PS^{EPS}	**156,092**[2]	21.03.17	n/a	21.03.20
LTIP PS^{TSR}	**194,279**[3]	20.03.18	n/a	20.03.21
LTIP PS^{EPS}	**194,280**[3]	20.03.18	n/a	20.03.21
LTIP PS^{TSR}	**254,932**[3]	20.03.19	n/a	20.03.22
LTIP PS^{EPS}	**254,932**[3]	20.03.19	n/a	20.03.22
	1,254,627			
LTIP SO	**102,004**[2]	23.03.16	4.99	23.03.19
LTIP SO	**503,106**[1]	21.03.17	6.49	21.03.20
	605,110			
LTIP RS	**129,002**	21.03.17	n/a	21.03.20
LTIP RS	**195,584**	20.03.18	n/a	20.03.21
LTIP RS	**256,643**	20.03.19	n/a	20.03.22
	581,229			

1. The outstanding award or option will lapse after the end of the financial year having not met the performance condition.
2. Subject to a performance condition that has been met.
3. Subject to a performance condition that is yet to be tested.

Performance Shares – nil cost options exercised during 2019

Peter Lynas

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
LTIP PS^{EPS}	17,255	nil	25.03.15	04.04.19	4.95
LTIP PS^{TSR}	7,717	nil	23.03.16	04.04.19	4.95

The Performance Shares nil-cost options exercised by Peter Lynas attracted notional reinvested dividends which equated to an additional 3,505 shares on exercise of these options (2,636 for the 2015 award and 869 for the 2016 award).

The tables above have been subject to audit.

Performance conditions

Performance conditions for the LTIP are detailed on page 127.

Remuneration Committee composition and advisers

The Committee members comprise Paula Rosput Reynolds (Chairman), Dame Elizabeth Corley and Nick Rose, together with Chris Grigg and Ian Tyler, who both joined the Committee at the beginning of 2020. Advisers to the Remuneration Committee are shown below.

During the year, the Committee received material assistance and advice on remuneration policy from the Group Human Resources Director, Karin Hoeing, and the Human Resources Director, Reward, Paul Farley. Charles Woodburn in his role as Chief Executive also provided advice that was of material assistance to the Committee.

Adviser	Services provided	Appointment	Governance	Fees (in respect of services provided to the Committee)
PricewaterhouseCoopers (PwC)	Independent adviser to the Committee, including attendance at Remuneration Committee meetings. Also provided information on market practice in relation to different aspects of remuneration, market trends and benchmarking of the remuneration packages for the executive population.	Committee appointment. 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 Committee is satisfied that the PwC LLP engagement partner and team, who provide remuneration advice to the Committee, do not have connections with the Group, or the individual directors, that may impair their independence and objectivity. PwC is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£88,800 Fee basis: Hourly
Linklaters	Provided legal services, principally regarding the directors' remuneration policy.	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 provide legal advice and services to the Company on a range of matters. Linklaters is regulated by the Law Society.	£7,159 Fee basis: Hourly
Aon	Advises on the TSR outcomes as required for assessing the performance condition under the BAE Systems Long-Term Incentive Plan 2014.	By the Company.	The Committee is aware that Aon provides a variety of other human resources-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. Aon is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£19,350 Fee basis: Fixed fee

Directors' remuneration policy

This Directors' remuneration policy (the Policy) will take legal effect from the conclusion of the 2020 Annual General Meeting (AGM) subject to shareholder approval at the 2020 AGM.

The Remuneration Committee (the Committee) considers the 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.

The Policy is to set base salary with reference to the relevant market-competitive level. We use target performance to estimate and benchmark the total potential reward against reward packages paid by BAE Systems' competitors. 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 more fully below.

The Committee is governed by Terms of Reference which set out their roles and responsibilities including how the Committee will be conducted and operate. These are reviewed at least annually to ensure they remain appropriate and include relevant corporate governance and other guidance. The Terms of Reference are available on the Company's external website. Our Long-Term Incentive Plan provides the Committee with discretion with respect of vesting outcomes that affect the actual level of reward payable to individuals; as explained on page 135, 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.

The Committee has appointed independent external advisers to receive material independent assistance and advice. In addition, to avoid any conflicts of interest or appearance thereof, no director is involved in deciding their own remuneration outcome with such items being discussed without their presence in the meeting.

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Note
References in this Policy to 'UK executive directors' are to UK-based executive directors and references to 'US executive directors' are to US-based executive directors.

Revisions compared to the policy approved at the 2017 AGM

The Policy contains no components which were not in the remuneration policy approved at the 2017 AGM. A description and explanation of all significant changes from the policy approved in 2017 are summarised below.

Annual incentive

- Confirmation that non-financial metrics will continue to be based on a combination of personal performance objectives linked to our strategic objectives, safety measures, and diversity and inclusion targets. However, from 2021, safety, diversity and inclusion targets will be reflected in the ultimate reward on the basis of being an 'underpin'. In other words, the Board expects safety, diversity and inclusion targets to be met in all circumstances; the Committee will, as a general matter, use its discretion to adjust the overall annual incentive in the event of below-target performance.

Long-Term Incentives (LTI)

- To continue the simplification of our LTI framework, since 2018, share options have not been granted to any executive directors. As a result, UK executive directors receive Performance Shares only and US executive directors receive a mix of Performance Shares and Restricted Shares, to maintain current Expected Value.
- Introduction of a cash generation measure and a metric reflecting strategic progress in addition to existing Earnings per Share (EPS) and relative Total Shareholder Return (TSR) conditions to apply to Performance Shares. Each metric will be equally weighted at 25%. Introduction of these additional measures is designed to capture the financial ambitions for the Company and provide focus on objectives that reflect our strategic priorities. Confirmation that we intend to disclose the areas of strategic progress in each year, but the specific metrics of measure will be disclosed prospectively only to the extent that they are not commercially sensitive.
- Maintain ability to adjust the weightings of the performance conditions and if considered appropriate, the Committee may introduce an alternate performance condition aligned to the Company's strategy, or remove a performance condition set out above, but with a minimum of 20% weighting always applying to the Total Shareholder Return (TSR) metric.
- Confirmation of the range of values possible for Performance Shares and Restricted Shares.

Pension

- Participation in executive defined contribution retirement plan (or cash equivalent) as default pension vehicle with 8% employer contribution for newly externally-appointed UK executive directors or internally-appointed UK executive directors, consistent with that available to the wider UK workforce in the Company's UK defined contribution arrangements.
- The annual value of the current Chief Executive's contributions will be fixed at the monetary value of his 2020 employer pension contribution of £186,200 per annum as a salary supplement. Assuming average salary increases in the region of 2.5% per annum, fixing the monetary value at this level will align the employer contribution rate applicable to the Chief Executive to the weighted average employer rate of 17% over a period of around four years.

Remuneration policy for other employees

- Confirmation that LTI grants will continue to be made in line with 2020 policy with the following differences:
  - for US participants below Executive Committee level, performance conditions and targets for performance share grants are tailored to reflect the strategic context and focus for the US business; and
  - share options may continue to be granted below executive director level without performance conditions attached and vest and are exercisable after three years.

Minimum Shareholding Requirement (MSR)

Acknowledging the relevant provisions of the Corporate Governance Code as well as broader expectations of investors in relation to MSR, the following have been introduced:

- Introduction of five-year time period achieving Minimum Shareholding Requirement (MSR) applicable to all executive directors.
- Continue to apply restriction on number of shares that can be sold on exercise or release, until the MSR is met. If less than 50% of MSR has been met, 50% of the net value (i.e. the value after deduction of exercise/sale costs and tax) of shares acquired through the various share schemes must be retained; if between 50% and 100% of MSR has been met, 25% of the net value must be retained. In the event that the executive director is still not compliant with their MSR at the end of the five-year period, the Committee will set out their proposed remedial actions at that time.
- Introduction of post-cessation shareholding policy applicable to all executive directors. For UK executive directors, the policy is based on the full MSR continuing to apply for a period of two years. For US executive directors, the policy is based on 300% MSR applying for a period of one year. Executive directors will be required to sign a contract on leaving employment to ensure compliance with this policy.

Non-executive directors' fees maximum opportunity

- Confirmation that the current Chairman's fee has been fixed at £700,000 from 1 February 2020 and is fixed at this level through the duration of his final term of office ending at the AGM in 2023.

Consideration of employment conditions elsewhere in the Company

Further details provided in relation to building the Committee's understanding of reward arrangements applicable to the wider workforce.

Stakeholder considerations

Further details provided in relation to the Committee's engagement with shareholders on the topic of executive remuneration.

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 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 net 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, 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: 225% of salary

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 payout for maximum performance is double the payout for on-target performance where maximum performance is shown as the respective maximum percentages above. The payout for achieving a threshold performance is 40% of the payout for on-target performance (i.e. 20% of maximum), with no payout for achieving less than this. Payout 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 aligned with long-term earnings and cash targets. The non-financial element will be based on a combination of personal performance objectives that provide a clear line of sight to our strategic objectives, safety measures, and diversity and inclusion targets*.

Metrics and weightings to be determined annually. Proposed metrics and weightings applicable in 2020:
Group EPS – 45%
Group cash – 22.5%
Order intake – 7.5%
Safety, and diversity and inclusion – 5%**
Key strategic objectives designed to support the Group's strategy – 20%

*See notes 4 and 5 on page 139 regarding the selection and weighting of performance metrics.

**Beginning in 2021, safety, and diversity and inclusion will be an underpin to the annual plan. At that point, Key strategic objectives will increase from 20% to 25% of the total weighting.

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 139 regarding the selection and weighting of performance metrics.

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 and 100% of face value for Restricted Shares):

- UK executive directors' awards will consist of Performance Shares only.
- 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), ensuring competitiveness of overall LTI opportunity in line with US market practice.

Performance metrics used, weighting and time period applicable

See below in relation to Performance Shares.

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 awards granted since the 2017 AGM, the Committee will have discretion over the number of awards vesting in light of other important factors in the business (reasonableness 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.

See notes 4 and 5 on page 139.

Long-Term Incentives – Performance Shares

Purpose and link to strategy

Direct financial measures of long-term earnings and cash generation that drive our financial ambitions for the Company, and external strategic measures including relative TSR performance, aligned to the interests of shareholders.

Operation

For UK 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 in three equal tranches 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 award of Performance Shares only) are as follows:

Chief Executive: 370% of salary

Chief Operating Officer: 350% of salary

Group Finance Director: 335% 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:

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.

Range of values: 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. The maximum value that an executive director can receive is based on this number of shares subject to the award multiplied by maximum vesting of 100%, multiplied by any share price growth between grant date and vesting date and including any dividend equivalents received in respect of vested shares. The minimum value that an executive director can receive is zero on the basis of nil vesting, for example either due to the performance conditions not being achieved, or as a result of the application of reasonableness discretion that determines nil vesting of the awards.

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):

- 25% 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 comparator 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 124.
- 25% 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.
- 25% of award based on three-year cumulative cash generation metric 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.
- 25% of award based on specific and quantifiable strategic goals, reflecting strategic progress, that are directly aligned to our company strategic goals of driving operational excellence, continuously improving competitiveness and efficiency and advancing and further leveraging our technology.

The metrics and weightings applicable in 2020 are as follows:

- 50% of award based on TSR relative to the following two comparator groups over the three-year performance period:
  - An appropriately sized group of 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 are 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 performance conditions, and, if considered appropriate, may introduce an alternate performance condition aligned to the Company's strategy, or remove a performance condition set out above, but with a minimum of 20% weighting always applying to the Total Shareholder Return (TSR) metric.

See notes 4 and 5 on page 139.

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). Directors are required to retain their shares for a further two-year period, except for any shares that need to be sold to cover tax liabilities due in respect of the shares. During that time, they are subject to clawback as described above. However, this holding requirement will not apply following a change of control. These awards are not subject to a performance condition as they are designed to address competitive market practice and retention issues principally in the US. Non-US-based 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:

Chief Executive Officer of BAE Systems, Inc.: 150% of salary

Range of values: 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. The value that a US executive director will receive is based on this number of shares subject to the award multiplied by the change in share price between grant date and vesting date and including any dividend equivalents received in respect of vested shares.

Performance metrics used, weighting and time period applicable

None.

See notes 4 and 5 on page 139.

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 parking and private use of a chauffeur-driven car and company aircraft, 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 118. 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 as at 19 February 2020 is a member of the defined contribution section of the BAE Systems Executive Pension Scheme (EPS DCRP). In line with our policy at the time of his appointment, Company contributions are 19% of salary and UK member contributions are 6% of salary. In the UK, the Company has a number of defined benefit (DB) plans which are closed to new entrants, with new hires being offered membership of a defined contribution (DC) pension scheme. Employer contribution rates for the different schemes range from 8% to approximately 50% salary. The level of employer contribution based on a weighted average of UK active members across all schemes is approximately 17%. From 2020, the annual value of the current Chief Executive's contributions will be fixed at the monetary value of his 2020 employer pension contribution of £186,200 per annum. Assuming broad average salary increases in the region of 2.5% per annum, fixing the monetary value at this level will align the employer contribution rate applicable to the Chief Executive to the weighted average employer rate of 17% over a period of around four years. The Committee will continue to monitor the matter of pension provision as part of a broader mix of total remuneration.

For any new externally-appointed UK executive directors, or internally-appointed UK executive directors, membership of the BAE Systems EPS DCRP is offered as the default pension vehicle. Company contributions are set at 8% of base salary for those members contributing 6% of salary, in line with that available to the wider UK workforce participating in the Company's UK defined contribution arrangements. In certain circumstances, individuals may elect instead to receive some or all of their Company contributions as a cash allowance. Consistent with the above, the Group Finance Director designate as at 19 February 2020[1] is a member of the BAE Systems EPS DCRP with Company contributions of 8% salary.

Where the Annual Allowance (AA) is breached, as is the case with the Chief Executive and the Group Finance Director designate, each individual will pay member contributions up to the AA limit and the Company contributions will be paid as a salary supplement. Where UK executive directors' pension entitlement or accrual is restricted to the Lifetime Allowance (LTA) and/or the AA, the Company may offer a salary supplement to offset the impact of these restrictions.

The current Group Finance Director as at 19 February 2020[1] is due to retire on 31 March 2020, before this Policy takes legal effect. He is a member of the BAE Systems Executive Pension Scheme and member 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. His contributions are currently 8% of salary in line with other members in the equivalent part of the scheme. This part of the scheme is a legacy arrangement and has not been open to new joiners for many years. Further detail is provided on page 125 as part of the Annual remuneration report.

The current Chief Executive Officer of BAE Systems, Inc. as at 19 February 2020[2] is due to step down from the Board on 31 March 2020, before this Policy takes legal effect. He 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. The same provisions and features of the plan apply to the majority of participating active employees.

Any new US executive directors, whether externally-appointed or internally-appointed, would be offered participation in the US Section 401(k) defined contribution plan. The same provisions and features of the plan currently apply to the majority of participating active employees, with the Company matching contributions up to a maximum of 6% of salary, subject to US regulatory limits. For any internally-appointed US executive directors who are also participants in the BAE Systems Employees' Retirement Plan (ERP, a qualified pension plan) and the BAE Systems 2007 Benefit Restoration Plan (BRP 2007, a non-qualified pension plan), these plans provide for either a lump sum or annuitised payments based on the accrued values at the time of separation from employment. Annual additional accruals are currently limited to $1,000 in the ERP and $500 in the BRP 2007.

The current President and Chief Operating Officer of BAE Systems, Inc. as at 19 February 2020 participates in a Section 401(k) defined contribution arrangement as described above, and is also a participant in the ERP and BRP 2007, as described above.

Maximum opportunity
The BAE Systems EPS DCRP provides a maximum Company contribution of 19% (in addition to employee contribution of 6%) of base salary in respect of the current Chief Executive. From 2020, the maximum Company contribution has been fixed at £186,200 per annum for the current Chief Executive.

The maximum Company contribution for any new externally-appointed UK executive directors, or internally-appointed UK executive directors is 8% (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 a salary supplement to offset the impact of these restrictions.

With limited exceptions, the US Section 401(k) defined contribution plan currently provides company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits. For US executive directors who are eligible to participate in the ERP and the BRP 2007, these plans provide a cash sum or annuity at retirement equal to the present value of all prior annual accruals and credits from the initial year of service eligibility through to the present. Since the start of 2013, annual additional accruals have been set at $1,000 from the ERP and $500 from the BRP 2007.

1. Peter Lynas, Group Finance Director as at 19 February 2020, is to retire on 31 March 2020. Brad Greve, Group Finance Director designate as at 19 February 2020, is to be appointed as Group Finance Director and a director of BAE Systems plc with effect from 1 April 2020.
2. Jerry DeMuro, Chief Executive Officer of BAE Systems, Inc. as at 19 February 2020, is to step down from the Board on 31 March 2020. Tom Arseneault, President and Chief Operating Officer of BAE Systems, Inc. as at 19 February 2020, will succeed Jerry DeMuro as President and Chief Executive Officer of BAE Systems, Inc. and director of BAE Systems plc with effect from 1 April 2020.

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 conditions and targets for Performance Share grants are tailored to reflect the strategic context and focus of the US business;
   - 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;
   - Restricted Share grants are currently made to the most senior managers in the US businesses reflecting competitive market practice and vest after three years. Targeted awards may also be made with Remuneration Committee approval to selected individuals outside the US below executive director level;
   - one quarter of the total annual incentive amount is subject to compulsory deferral for three years in BAE Systems shares without any matching for UK and Rest of World participants that receive LTI grants; and
   - Minimum Shareholding Requirements are in place for all of the approximately 400 individuals globally that receive LTI grants.

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 as appropriate.
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 as set out in the table below. Executive directors are required to achieve their Initial Value as quickly as possible, and achieve their Subsequent Value within a five-year time period. Where an executive director has not achieved their MSR, the consequence is a restriction on the number of shares that can be sold on exercise or release, until their MSR Subsequent Value is met. Where an executive director has met less than the Initial Value (50% of their MSR), they must retain 50% of the net value (i.e. the value after deduction of exercise/sale costs and tax) of shares acquired through the various share schemes; if they have met the Initial Value but not the Subsequent Value (i.e. between 50% and 100% of their MSR), they must retain 25% of the net value. In the event that the executive director has not met the Subsequent Value at the end of the five-year period, the Committee will set out their proposed remedial actions at that time. 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.

   With effect from the 2020 AGM, where an executive director leaves employment for any reason, a post-cessation shareholding policy will apply. For UK executive directors, the policy is based on the full MSR continuing to apply for a period of two years. For US executive directors, the policy is based on 300% MSR applying for a period of one year. Executive directors will be required to sign a contract on leaving employment to ensure compliance with this policy. Any case of non-compliance would be dealt with by the Committee.

   The following table sets out MSR Initial Value and Subsequent Value:

	Initial Value	Subsequent Value
Chief Executive	150%	300%
Chief Operating Officer	100%	200%
Group Finance Director	100%	200%
Chief Executive Officer of BAE Systems, Inc.	212.5%	425%

Executive directors' policy table continued

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. No illustration of Remuneration Policy is shown for Peter Lynas (current Group Finance Director) and Jerry DeMuro (current Chief Executive Officer of BAE Systems, Inc.) who are stepping down from the Board in advance of the 2020 AGM at which the proposed Remuneration Policy is being put to shareholders, as set out in the executive director changes below.

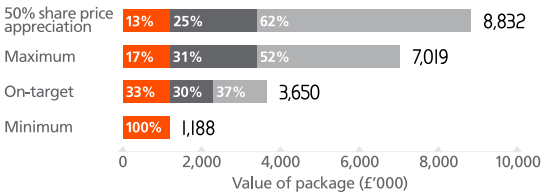
The values are based on 2020 levels for base salaries, benefits and pension and assume that the office-holders at the date of this Policy coming into effect are employed throughout the first year of operation of the Policy. Annual and long-term incentives are based on awards applying in 2021. The charts assume the following scenarios:

- minimum fixed pay includes salary, benefits and pension as provided in the single figure table on page 118 of the Annual Report and Restricted Shares award for the US executive director awarded at 150% salary (excluding share price growth);
- on-target pay assumes on-target performance is met in respect of variable elements (annual and long-term incentives);
- maximum pay assumes variable elements pay out in full; and
- 50% share price appreciation assumes all variable elements pay out in full and there is 50% gain in share price over the relevant vesting period in respect of Performance Shares and Restricted Shares awards received, and excludes dividends.

The minimum, on-target and maximum scenarios below exclude any share price appreciation and dividends.

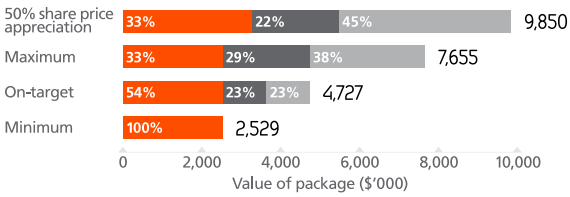
Chief Executive

(£'000)



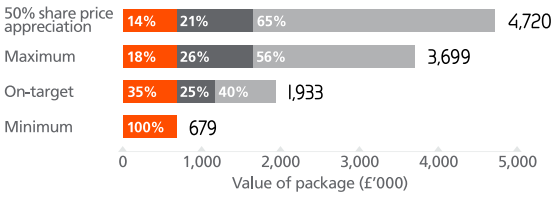
President and Chief Executive Officer of BAE Systems, Inc.

($'000)



Group Finance Director

(£'000)



Executive directorship changes

As announced on 8 August 2019, Peter Lynas is to retire as Group Finance Director on 31 March 2020 and Brad Greve, Group Finance Director designate, is to be appointed as Group Finance Director and a director of BAE Systems plc on 1 April 2020. As announced on 17 December 2019, Jerry DeMuro is to retire on 31 December 2020, stepping down from his role as executive director on 31 March 2020. Tom Arseneault will succeed him as President and Chief Executive Officer of BAE Systems, Inc. and a director of BAE Systems plc on 1 April 2020.

- Fixed elements of remuneration
- Annual bonus
- Performance Shares

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 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 2020 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. The Company reimburses 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 LTIP SO and ExSOP[2012] that remain outstanding. 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.

Recruitment

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 Committee determines the remuneration package for any appointment to an executive director position, either from within or outside BAE Systems.

Operation
The 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 141.

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 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. In the case of pensions however, any previous arrangement will cease and the individual will be offered provision in line with the agreed policy on page 138.

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 subject to the maximums referred to 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 137.

Service contracts and letters of appointment

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
Charles Woodburn[1]	1 July 2017	12 months either party
Peter Lynas[2]	1 April 2011	12 months either party
Jerry DeMuro[3]	1 February 2014	90 days either party
Brad Greve[4]	1 April 2020	12 months either party
Tom Arseneault[5]	1 April 2020	60 days either party

1. Appointed to the Board as Chief Operating Officer on 9 May 2016; appointed as Chief Executive with effect from 1 July 2017.
2. Retires from the Board and the Company on 31 March 2020 as announced on 8 August 2019.
3. Retires from the Board and as Chief Executive Officer of BAE Systems, Inc. on 31 March 2020 as announced on 17 December 2019. Jerry DeMuro's contract of employment automatically renewed for one-year periods from 31 December each year, unless one party gave at least 90 days' notice of non-renewal.
4. Appointed as Group Finance Director designate with effect from 1 September 2019 and will join the Board on 1 April 2020 as announced on 8 August 2019.
5. President and Chief Operating Officer of BAE Systems, Inc., he will join the Board and become Chief Executive Officer of BAE Systems, Inc. on 1 April 2020 as announced on 17 December 2019. His contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives the other at least 60 days' notice.

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 second three-year term and has been extended until the conclusion of the Company's Annual General Meeting in May 2023, 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
Revathi Advaithi	01.01.2018	31.12.2020
Dame Elizabeth Corley	01.02.2016	01.02.2022
Chris Grigg	01.07.2013	30.06.2022
Stephen Pearce	01.06.2019	31.05.2022
Nicole Piasecki	01.06.2019	31.05.2022
Paula Rosput Reynolds	01.04.2011	31.03.2021
Nick Rose	08.02.2010	31.03.2020
Ian Tyler	08.05.2013	07.05.2022

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.

Service contracts and letters of appointment continued

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. Where appropriate the Company may also meet a director's reasonable legal expenses in connection with their termination of their appointment.

Notice and pay in lieu of notice
For executive directors, employment contracts will generally be on terms that allow them to be terminated on up to 12 months' notice from either party or 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.

For US-based executive directors, employment contracts are typically for one-year periods and renew automatically unless one party gives at least 60 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) the executive director resigns for a 'Good Reason' (as defined in the contract), the executive director 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. They will also be entitled to a continuation of medical benefits for 18 months (or a cash payment in lieu).

In all cases, the Committee seeks to include provisions in directors' employment contracts to allow the Company to pay any notice or severance payments on a phased basis and apply mitigation if the executive director secures alternative employment, to the extent that this is reasonably practicable taking into account local labour law, tax and other relevant considerations.

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. In all cases, 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 Chief Executive Officer of BAE Systems, Inc. and the applicable treatment is provided in the section on notice and pay in lieu of notice.

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 has responsibility for reviewing remuneration and related policies applicable to the wider workforce. To support this, the Committee is provided with periodic deep dive sessions on a range of wider workforce remuneration topics that are designed to provide the Committee with visibility of remuneration practices in the different sectors/markets in which we operate and for the different populations within the wider workforce across the Company globally. This enables the Committee to take the wider workforce into account when setting the policy for executive remuneration. Whilst the Committee does not consult directly with employees as part of the process for reviewing executive pay, the Committee does receive insights from the broader employee population via an engagement survey. 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

In line with our commitment to full transparency and engagement with our shareholders on the topic of executive remuneration, the Remuneration Committee Chairman conducts an annual programme of consultation with major shareholders. This typically involves setting out the changes planned for the following year, including seeking shareholder input and views to various executive remuneration matters including the development of, or potential changes to, remuneration policy or arrangements.

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 2019 financial year are listed on pages 86 and 87. Stephen Pearce and Nicole Piasecki were appointed to the Board on 1 June 2019. Harriet Green also served on the Board until 7 November 2019.

As previously announced by the Company, Peter Lynas and Jerry DeMuro will retire from the Board on 31 March 2020 and will be succeeded respectively by Brad Greve and Tom Arseneault on 1 April 2020. Nick Rose will also retire from the Board on 31 March 2020.

Dividend
An interim dividend of 9.4p per share was paid on 2 December 2019. The directors propose a final dividend of 13.8p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2020 to shareholders on the share register on 17 April 2020. Information on dividend waivers is given on page 212.

Annual General Meeting (AGM)
The Company's AGM will be held on 7 May 2020. 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 81:

- disclosures in relation to the use of financial instruments;
- particulars of important events affecting the Group which have occurred since 31 December 2019;
- 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;
- greenhouse gas emissions;
- employee engagement (including regard to employee interests and encouraging employees to be shareholders); and
- fostering business relationships with suppliers, customers and others.

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 half-year results announcement on 31 July 2019, the Group made the following statement in respect of the year ending 2019, which is regarded as a profit forecast for the purposes of the Financial Conduct Authority's Listing Rule 9.2.18 (and which amended the profit forecast made in the Group's full-year results announcement on 21 February 2019 and in the Annual Report 2018):

"Whilst the Group is subject to geopolitical uncertainties, the following guidance is provided on current expected operational performance. We expect the Group's underlying earnings per share (excluding the one-off tax benefit) to grow by mid-single digit compared to the full year underlying earnings per share in 2018 of 42.9p, assuming a $1.30 to sterling exchange rate."

Underlying earnings per share was 45.8p in 2019 (excluding the one-off tax benefit).

Employees
The Group is committed to giving open, full and fair consideration to applications for employment from disabled people and people with health conditions or impairments who meet the requirements for roles, and making available training opportunities and appropriate accommodation to everyone employed by the Group, because we firmly believe that inclusion of all of our people, enabling them to contribute to the best of their ability, is vital to our business. Our commitment to disability inclusion and accessibility in the workplace can also be recognised through our pledge to support The Valuable 500 campaign.

Political donations
No political donations were made in 2019.

Issued share capital
As at 31 December 2019, 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 2019, the number of shares held in treasury totalled 271,650,137 (having a total nominal value of £6,791,253 and representing 7.8% of the Company's called up share capital at 1 January 2019). During 2019, the Company used 9,752,386 treasury shares (having a total nominal value of £243,810 and representing 0.3% of the Company's called up share capital at 31 December 2019) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (5,947,775 shares in aggregate), awards under the Free and Matching elements of the International Share Incentive Plan (588,462 shares in aggregate), awards vested under the Performance Share Plan and Performance Shares element of the Long-Term Incentive Plan (1,032,720 shares), awards vested under the Restricted Shares element of the Long-Term Incentive Plan (1,458,971 shares), and options exercised under the Executive Share Option Plan (724,458 shares). The treasury shares utilised in respect of the Share Incentive Plan, the International Share Incentive Plan, and the Performance Share Plan and the Performance and Restricted Shares elements of the Long-Term Incentive Plan were disposed of by the Company for nil consideration. The 724,458 shares disposed of by the Company in respect of the Executive Share Option Plan were disposed of by the Company for an aggregate consideration of £3,094,548. As at 31 December 2019, the number of shares held in treasury totalled 261,897,751 (having a total nominal value of £6,547,444 and representing 7.6% of the Company's called up share capital at 31 December 2019).

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 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, 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 2019, 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.	4.93%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	4.97%
Silchester International Investors LLP	3.01%

Since 31 December 2019 the Company has been advised that the interest of The Capital Group Companies, Inc. has increased to 5.02%.

Exercise of rights of shares in employee share schemes
The trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

Restrictions on voting deadlines
The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

Appointment and replacement of directors
Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The 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.

All directors will stand for election or re-election in 2020 as required by the Company's Articles of Association and 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 2019 AGM, the directors were given the power to buy back a maximum number of 319,696,861 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 by Regulatory Technical Standards adopted by the European Commission pursuant to article 5(6) of the Market Abuse Regulation.

This power will expire at the earlier of the conclusion of the 2020 AGM or 30 June 2020. A special resolution will be proposed at the 2020 AGM to renew the Company's authority to acquire its own shares.

At the 2019 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,638,740. This power will expire on the earlier of the conclusion of the 2020 AGM or 30 June 2020. Accordingly, a resolution will be proposed at the 2020 AGM to renew the Company's authority to issue further new shares.

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 2019 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 entered into a £2bn Revolving Credit Facility dated 12 December 2013 which was amended and restated on 30 April 2018. The facility 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 2019.
- The Group entered into a US$1,925,000,000 Bridge Loan Facility Agreement dated 17 January 2020 in relation to the proposed acquisition of Collins Aerospace's Military Global Positioning System business. The facility provides that, in the event of a change of control of the Company after the date of first drawdown, 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 Bridge Loan Facility Agreement was undrawn as at 19 February 2020.
- 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 June 2017, BAE Systems Surface Ships Limited entered into a contract with the UK Ministry of Defence (MoD) for the manufacture of the first batch of three Type 26 frigates. 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 or where the change of control would result in increased costs to the MoD under the contract, 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 on such grounds, then the MoD may terminate the contract with immediate effect.
- The MSDF agreement between BAE Systems Surface Ships Limited and the MoD became effective on 1 October 2014 and establishes a framework 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. In March 2016, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 6 of the Astute Class Programme. In March 2018, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 7 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 initial phase of manufacturing activities for the Dreadnought Class programme. This contract was extended and amended to include additional manufacturing activities in March 2018. 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 2018, BAE Systems' subsidiary, ASC Shipbuilding Pty Limited, entered into a contract providing the framework for the design and manufacture of Hunter Class frigates for the Royal Australian Navy (Head Contract). As part of the acquisition of ASC Shipbuilding Pty Limited from the Australian Commonwealth, BAE Systems Australia Limited entered into a Sovereign Capability and Option Deed (SCOD). Under the Head Contract and the SCOD, if there is a change of control of ASC Shipbuilding Pty Limited, BAE Systems Australia Limited or BAE Systems plc, consent is required from the Australian Commonwealth Government prior to any change of control occurring. If there is a change of control without notice or notwithstanding an objection, the Commonwealth may terminate the Head Contract, take any action to mitigate an actual or potential threat to Australia's national security interests, or exercise its call option under the SCOD and regain ownership of ASC Shipbuilding Pty Limited.

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.

Auditor
Deloitte LLP have indicated their willingness to be re-appointed as the Company's auditor and a resolution proposing their re-appointment will be put to the 2020 AGM.

Statement of directors' responsibilities in respect of the Annual Report and the financial statements
The directors are responsible for preparing the Annual Report, and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law, they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards as adopted by the European Union (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, 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, relevant, reliable 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;
- assess the Group and parent company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Group or the parent company or to cease operations, or have no realistic alternative but to do so.

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 are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and 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 auditor
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 auditor is 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 auditor is aware of that information.

Responsibility statement of the directors in respect of the Annual Report and financial statements
Each of the directors listed below confirms that to the best of their knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company, and the undertakings included in the consolidation taken as a whole; and
- the 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
Charles Woodburn	Chief Executive
Jerry DeMuro	Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Revathi Advaithi	Non-executive director
Dame Elizabeth Corley	Non-executive director
Chris Grigg	Non-executive director
Stephen Pearce	Non-executive director
Nicole Piasecki	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
19 February 2020

Directors' report
The Directors' report was approved by the Board of directors on 19 February 2020.

David Parkes
Company Secretary

Independent Auditor's report

to the members of BAE Systems plc only

Opinion

In our opinion:

- the financial statements of BAE Systems plc (the Parent Company) and its subsidiaries (the Group) give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2019 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 (IFRSs) as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 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.

We have audited the financial statements which comprise:

- the consolidated income statement;
- the consolidated and Parent Company statement of comprehensive income;
- the consolidated and Parent Company statements of changes in equity;
- the consolidated and Parent Company balance sheets;
- the consolidated cash flow statement; and
- the related notes 1 to 36, including the associated accounting policies.

The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRSs as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the Parent Company financial statements is applicable law and United Kingdom Accounting Standards, including FRS 101 Reduced Disclosure Framework (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Group and the Parent Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the FRC's) Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Parent Company. The non-audit services provided to the Group and Parent Company for the year are disclosed in note 2 to the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters

The key audit matters that we identified in the current year were:

- revenue and margin recognition on long-term contracts;
- carrying value of goodwill; and
- valuation of post-employment benefit obligations.

These are consistent with the prior year.

Key audit matters with increased, stable or lower levels of risk compared to the prior year are identified with ⌃, ⟷ and ⌄.

Materiality

We concluded that users of the financial statements would consider errors in excess of £75 million to be material, determined on the basis of adjusted profit before tax on continuing operations as defined on page 154 below. Errors in excess of this amount would equate to more than 4.8% of adjusted profit before tax and 4.6% of profit before tax.

Scoping

23 components were subject to audit procedures. Of these, six components were subjected to a full-scope audit. The remaining 17 were subject to an audit of specified account balances. These components contribute 94% of revenue, 79% of profit before tax and 81% of net assets.

Significant changes in our approach

There have been no significant changes in our approach this year.

Conclusions relating to going concern, principal risks and viability statement

Going concern

We have reviewed the directors' statement in the Basis of preparation on page 158 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's and Parent Company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We considered as part of our risk assessment the nature of the Group, its business model and related risks including, where relevant, the impact of Brexit, the requirements of the applicable financial reporting framework and the system of internal control. We evaluated the directors' assessment of the Group's ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors' plans for future actions in relation to their going concern assessment.

We are required to state whether we have anything material to add or draw attention to in relation to that statement required by Listing Rule 9.8.6R(3) and report if the statement is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Principal risks and viability statement

Based solely on reading the directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors' assessment of the Group's and the Parent Company's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on pages 78 to 81 that describe the principal risks, procedures to identify emerging risks and an explanation of how these are being managed or mitigated;
- the directors' confirmation on page 89 that they have carried out a robust assessment of the principal and emerging risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity; or
- the directors' explanation on page 89 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We are also required to report whether the directors' statement relating to the prospects of the Group required by Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those that had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Revenue and margin recognition on long-term contracts

Refer to page 91 (Audit Committee report) and note 1 (accounting policy and financial disclosure)

Revenue:
£18,305m (2018 £16,821m)

Key audit matter description

The estimation of both overall lifetime contract margin and the appropriate level of revenue and profit to recognise in any single accounting period require the exercise of management judgement. Within BAE Systems' contract portfolio there are a number of programmes where the estimates required in reaching these judgements are complex and could lead to a material error within the financial statements if reached incorrectly. Consequently, we consider that revenue and margin recognition represents a significant risk to our audit and a key audit matter.

We focus a greater proportion of audit effort on a number of contracts where we consider there to be the highest degree of management judgement required, and design contract-specific tests and procedures to mitigate the associated risks.

In order to identify the key contracts where there is a significant risk of material misstatement, we undertook a contract risk assessment process at each component, utilising the latest contract information, our understanding of the business and review of external information about market and geopolitical conditions which might impact certain contracts. We held meetings with key finance and contract managers, attended Quarterly Business Reviews and other key management meetings, read and understood underlying contract documentation and reviewed management support for key contract judgements. In addition, we looked for contracts that might have higher levels of judgement associated with the risk of schedule delivery or technical complexity, fixed price contracts which increase the risk of contract losses and other indicators that could increase the risk of a material impact on the financial statements.

As a result of our risk assessment we identified four contracts where we consider there to be the highest degree of management judgement required. These are:

- Astute Class submarines;
- Type 26 frigate;
- Saudi Salam Typhoon (Salam); and
- Saudi British Defence Co-operation Programme (SBDCP).

We consider the level of risk associated with this key audit matter has remained consistent with the prior year. As a result of developments during the year we have removed the Offshore Patrol Vessel, Queen Elizabeth carrier and Radford Nitrocellulose plant contracts from our identified significant risk. The Type 26 frigate contract has been added as a new significant risk contract in the current year.

How the scope of our audit responded to the key audit matter

Our contract testing approach included:

Testing the relevant controls on significant contracts

- We obtained an understanding of and, where deemed appropriate, tested the key manual and IT controls within management's Lifecycle Management (LCM) Framework and project accounting processes which management have established to ensure that contracts are appropriately forecast, managed, challenged and accounted for.
- As part of this, we observed the controls in operation by attending a sample of project contract status review meetings, Quarterly Business Review meetings and Group-level meetings to validate the various levels of challenge applied to the forecasts.

Challenging management's assumptions and estimates on significant risk contracts

To gain assurance over the contract judgements and estimates made, our work included:

- making enquiries of contract project teams and other personnel to obtain an understanding of the performance of the project throughout the year and at year-end;
- analysing historical contract performance and understanding the reason for in-year movements or changes;
- testing the underlying calculations used in the contract assessments for accuracy and completeness, including the estimated costs to complete the contract alongside associated contingencies. As part of this we considered historical forecasting accuracy of costs, including on similar programmes, and challenged future cost expectations with reference to those data points;
- examining external correspondence to support the timeframe for delivery of the product or service and any judgements made in respect of these;
- examining external evidence to support contract status and estimation of variable consideration (including associated recoverability of contract balances), such as customer correspondence and for certain contracts, meeting with the customer directly;
- enquiring with in-house and external legal counsel regarding contract-related litigation and claims; and
- considering whether there were any indicators of management override of controls or bias in arriving at their reported position.

Key observations

The results of our testing were satisfactory.

Through our testing of significant risk contracts we did not identify any audit adjustments and consider the judgements made by management in recognising revenue and profit to be reasonable. We noted an increased level of judgement required in the current year in determining consideration under IFRS 15 when there was increased uncertainty about the potential recoverability of amounts on certain contracts.

Our testing of the remaining population identified certain immaterial audit adjustments but we conclude overall that the judgements made by management are reasonable.

Carrying value of goodwill

Refer to page 91 (Audit Committee report) and note 8 (accounting policy and financial disclosures)

Goodwill:
£9,984m (2018 £10,239m)

Key audit matter description

The Group holds material goodwill balances relating to UK and overseas acquisitions, the majority of which are in the US. Management performs an impairment review of the carrying value of each Cash-Generating Unit (CGU) on an annual basis in line with the requirements of IAS 36.

The impairment assessment involves management judgement in considering whether the carrying value of the CGU is recoverable. Determining the recoverable amount involves significant estimation including:

- forecasting future cash flows;
- determining the discount rate; and
- determining future growth rates.

As a result of market changes, discount rates have generally fallen since the prior year which, in conjunction with certain other factors, has provided more headroom in management's impairment assessments. As such, this area is no longer considered a key source of estimation uncertainty by the Group.

In planning our audit, we determined there to be a heightened level of impairment risk in relation to the carrying value of goodwill associated with the Platforms & Services (US) (P&S), Applied Intelligence (AI) and Land Munitions (Land) CGUs. These CGUs have goodwill of £3,428m, £206m and £427m, respectively. Unlike in the prior year, where we identified a significant risk over the carrying value of goodwill in AI, we have not identified a significant risk associated with any CGUs in the current year, due to the increased levels of headroom as explained above.

The size of the balance and the level of audit effort involved in assessing the carrying value of goodwill means we consider this to be a key audit matter.

Through our risk assessment, we determined that the key drivers of future cash flows in each CGU were as follows:

- **P&S:** future demand, long-term contract margin and operating cash flow assumptions, predominantly within the Combat Vehicles business;
- **AI:** impact of current year restructuring on future revenue and margin growth assumptions for the remaining business, as a result of the announced exit of the Technology & Commercial business; and
- **Land:** future demand linked to renewal of key programmes and long-term contract margin assumptions.

As a result, we have performed additional procedures over these key cash flow assumptions.

How the scope of our audit responded to the key audit matter

We have performed a series of specific audit procedures to address the key audit matter identified in relation to these CGUs. This included the following:

- we obtained a detailed understanding of management's process and key controls for performing the CGU impairment assessment. Specific focus was given to understanding management's process and controls over forecasting future cash flows and determination of the key assumptions as detailed above;
- we challenged forecast performance with reference to the recent and historical performance of each CGU, historical forecasting accuracy, external industry benchmarks and specific forecast events. This included performing sensitivity analysis to evaluate the impact of changing a range of assumptions including suppressed growth, lower margin assumptions and changes in the discount rate;
- we critically assessed the risks and opportunities identified by management in their forecasts and modelled different scenarios to understand the impact of both adverse and positive changes to the future forecasts and the level of associated headroom;
- where the cash flows assumed significant contract renewals or an extension to existing contracts (i.e. moving from initial to full rate of production) we challenged those judgements with operational management and, where relevant, correspondence with the customer over contract renewal;
- operating cash flow and working capital assumptions were challenged with reference to our revenue contract audit work for key programmes, as well as historical trends for each line of business;
- we tested the integrity of management's impairment model used to derive the recoverable amount; and
- we involved Deloitte valuation specialists to support our challenge of the applicable discount rate.

Key observations

We completed our audit of the forecasts of the P&S, AI and Land businesses and are satisfied that management's assumptions are reasonable and supportable based on available evidence, both internal and external.

Management has concluded that no reasonably possible change in a key assumption would lead to impairment and we concur with that conclusion.

Valuation of post-employment benefit obligations

Refer to page 91 (Audit Committee report) and note 23 (accounting policy and financial disclosures)

Group's share of the net IAS 19 deficit after allocation to equity accounted investments:
£4,455m (2018 £4,029m)

Valuation of post-employment benefit obligation assets:
£27,687m (2018 £25,653m)

Valuation of post-employment benefit obligation liabilities:
£32,466m (2018 £29,986m)

Key audit matter description

The principal post-employment benefit schemes are held in the UK and US and are funded defined benefit schemes, with assets held in separate trustee-administered funds.

We identified the following areas which were the focus of our procedures in auditing the Group's net post-employment benefit obligations as a key audit matter:

Liabilities

The key judgements relating to the post-employment benefit obligations include:

- inflation assumptions;
- discount rates; and
- mortality assumptions.

Given the significant size of the deficit at year-end, small changes to these input assumptions can lead to material changes in the valuation. Assumptions are also made in the determination of the Group's share of assets and liabilities of multi-employer schemes in which it participates and the corresponding amounts attributed to other participating employers.

Assets

Given the size and nature of the scheme assets there is significant audit effort required in ensuring the valuation of assets is supportable.

Certain asset classes are inherently more judgemental to value and have a higher level of associated valuation risk, namely:

- private equity investments;
- pooled investment vehicles without published market prices;
- private placements; and
- longevity swaps.

How the scope of our audit responded to the key audit matter

Liabilities

In relation to the post-employment benefit obligations we have performed the following procedures:

- we obtained a detailed understanding and performed walkthroughs of management's process, with specific focus on understanding key controls relating to the valuation of the post-employment benefit obligation including maintenance of membership data;
- in conjunction with Deloitte actuarial specialists, we challenged the assumptions used in the IAS 19 valuation, including assessing and challenging the reasonableness of the assumptions against available market data and benchmarking against their peers;
- we have assessed the competence, capabilities and objectivity of the third-party administrators who maintain membership data on behalf of the Group and performed analytical procedures to challenge key changes in membership data since the last triennial valuation (March 2017), the most recent pension scheme accounts (March 2019) and that used in the IAS 19 valuation; and
- we assessed the competence, capabilities and objectivity of the actuaries engaged by management to perform the valuations of the schemes.

Assets

In relation to asset valuations we have performed the following procedures with increased focus on those assets with a higher valuation risk as noted above:

- we tested the pension asset valuation controls for certain asset classes;
- we performed audit procedures relating to the assets held within the pension schemes through seeking third-party confirmation from asset managers and/or custodians or other supporting evidence as appropriate; and
- we reviewed publicly available information on the assets, comparing to internal benchmarks and reconciling inputs used by management to determine the asset values.

Key observations

Overall, we consider the discount rate and other key pension assumptions used by management in calculating the post-employment benefit obligation to be within our independently-developed reasonable range.

We concluded our testing of the assets and are satisfied they are appropriately valued.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Parent Company financial statements
Materiality	£75m (2018 £70m)	£46m (2018 £38.5m)
Basis for determining materiality	4.8% of adjusted profit before tax of £1,575m. This includes adjustment for non-recurring items of £27m (see note 1) and fair value and foreign exchange adjustments on financial instruments and investments of £78m (see note 5).	Materiality has been set with reference to the net assets of the Parent Company.
Rationale for the benchmark applied	Adjusted profit before tax from continuing operations was considered to be the most relevant benchmark as it is considered the most stable and comparable profit metric. The adjustments excluded relate to items that are considered one-off in nature or relate to complex financial instrument valuations, which are volatile and not reflective of the underlying performance of the business. We consider the measure suitable having also considered the other relevant benchmarks of profit before taxation, where our materiality equates to 4.6%.	This represents 1% of the Parent Company net assets. In addition, we consider the materiality of the Parent Company in the context of the Group materiality and have capped this at 55% of that of the Group. We consider net assets the key benchmark used by members of the Parent Company in assessing financial performance.
Component materiality	Audit work at the 23 components identified in our Group audit scope (excluding the Parent Company) was completed to a component materiality level between £21m and £34m (2018 £18m to £38.5m).	
Performance materiality	We set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole. Group performance materiality was set at 70% of Group materiality for the 2019 audit (2018 70%). In determining performance materiality, we considered the following factors: – the quantum and nature of the uncorrected misstatements identified in the prior year audit; – our assessment of the potential for uncorrected misstatements in the current year; – the size and nature of the contract-based significant risks of material misstatement identified; – the fact two of our three key audit matters are audited centrally by the Group audit team; and – our planned reliance on controls for a number of areas of the audit for the current year.	
Error reporting threshold	We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £3.75m (2018 £3.5m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.	

An overview of the scope of our audit

Our Group audit was scoped by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the audit risks. This exercise has considered the relative size of each reporting unit's contribution to revenue, profit before tax and adjusted profit before tax, alongside further financial or contractual risks which we consider to be present.

We have considered units that contribute more than 10% of the Group's revenue or adjusted profit before tax to be 'financially significant', and requiring a full-scope audit. In addition, as part of our risk assessment procedures and using our knowledge of the business, we assess where else we consider it appropriate to perform a full-scope audit. This resulted in full-scope audits for six components located in the UK, Saudi Arabia and the US, and included the Group's largest joint venture, MBDA.

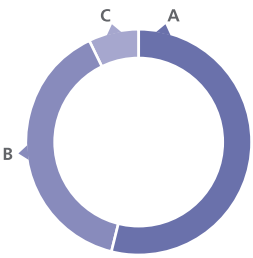
Additionally our audit planning identified 17 non-financially significant components, located in the UK, Saudi Arabia, Australia and the US, where we consider there to be a reasonable possibility of material misstatement in specific balances within the financial statements. Accordingly, we have directed component auditors to perform an audit of specified account balances and additional analytical procedures on the respective income statements and balance sheets for these components.

For all in-scope components, whether designated financially significant or subject to an audit of specified account balances, revenue was determined to be in scope for the audit.

For all other reporting units not included in full-scope or audit of specified account balance scope, we performed centrally-directed analytical review procedures to confirm our conclusion that there was no significant material misstatement in the residual population.

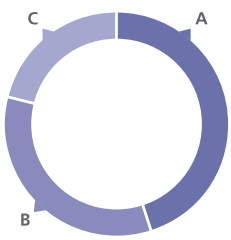
The 23 components within the scope of our audit work contribute the following proportions of the total Group results:

Revenue



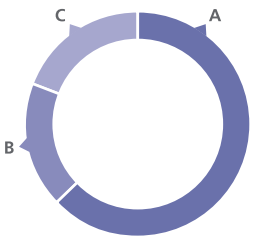
A	Full audit scope	54%
B	Specified account balances	39%
C	Review at a Group level	7%

Profit before tax



A	Full audit scope	45%
B	Specified account balances	34%
C	Review at a Group level	21%

Net assets



A	Full audit scope	63%
B	Specified account balances	18%
C	Review at a Group level	19%

As each of the business units maintains separate financial records, we have engaged component auditors from the Deloitte member firms in the US, UK, Saudi Arabia and Australia to perform procedures at all the wholly-owned components under our direction and supervision. This approach also allows us to engage local auditors who have appropriate knowledge of local regulations to perform the audit work, under a common Deloitte audit approach.

In respect of MBDA, we have engaged with the entity's non-Deloitte auditor to perform a full-scope audit under our direction and supervision.

Working with other auditors

We have issued detailed instructions to the component auditors, directed and supervised their work through a number of visits to each of the component auditors during the planning and performance stages of our audit, alongside frequent remote communication and review of their work.

Our oversight of component auditors focused on the planning of their audit work and understanding of their risk assessment process to identify key areas of estimates and judgement, as well as the execution of their audit work in line with our Group-issued referral instructions. All teams were involved in our annual planning workshop, which was overseen and directed by the Group audit team. We are satisfied that the level of involvement of the Group audit partner and team in the component audits has been extensive and has enabled us to conclude that sufficient appropriate audit evidence has been obtained in support of our opinion on the Group financial statements as a whole.

The BAE Systems, Inc. business units in the US are subject to a Department of Defense Special Security Arrangement (SSA), which is a government requirement setting out specific protocol that foreign-controlled companies must comply with in order to be able to undertake government defence contracts. As part of this there is restriction on the flow of information outside of the US. Therefore, for the US components there are restrictions around access to the audit file and specific workpapers for non-US nationals. As such we have designed alternative procedures, including involvement of an additional independent US national partner, to ensure that appropriate oversight of the US component team is obtained.

In addition to the work performed at a component level, at Group level we have audited the consolidation process and carried out analytical procedures over the residual financial information of the remaining components not subject to audit or audit of specified account balances. At a Group level we also perform audit procedures on centrally-held balances including treasury, post-employment benefit obligations, goodwill, tax, head office costs and litigation and claims.

Other information

The directors are responsible for the other information. The other information comprises the information included in the Annual Report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- **Fair, balanced and understandable –** the statement given by the directors that they consider 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, is materially inconsistent with our knowledge obtained in the audit; or
- **Audit Committee reporting –** the section describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee; or
- **Directors' statement of compliance with the UK Corporate Governance Code –** the parts of the directors' statement required under the Listing Rules relating to the Group's compliance with the UK Corporate Governance Code containing provisions specified for review by the auditor in accordance with Listing Rule 9.8.10R(2) do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code.

We have nothing to report in respect of these matters.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Parent Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Extent to which the audit was considered capable of detecting irregularities, including fraud

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, our procedures included the following:

- enquiring of management, internal legal counsel, internal audit and the Audit Committee, including obtaining and reviewing supporting documentation, concerning the Group's policies and procedures relating to:
  - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
  - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud; and
  - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations, including obtaining an understanding of the Group's bribery and corruption and whistleblowing policies;
- discussing among the engagement team, including significant component audit teams and involving relevant internal specialists, including tax, valuations, pensions and IT specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud. As part of this discussion, we identified potential for fraud in relation to the level of judgement involved in estimating costs to complete on long-term contracts and the subsequent impact on revenue and margin recognition; and
- obtaining an understanding of the legal and regulatory frameworks that the Group operates in, focusing on those laws and regulations that had a direct effect on the financial statements, including the UK Companies Act, Listing Rules, pension and taxation legislation. In addition, owing to the sector the Group operates in, we considered laws and regulations that had a fundamental effect on the operations of the Group, including in respect of export controls, defence contracting and anti-bribery and corruption legislation. These areas were identified through enquiries with directors, management and legal counsel, our knowledge and understanding of the Group accumulated throughout the audit and our sector-specific experience.

Audit response to risks identified

As a result of performing the above, we identified revenue and margin recognition on long-term contracts as a key audit matter. The key audit matters section of our report explains the matter in more detail and also describes the specific procedures we performed in response to the key audit matter.

In addition to the above, our procedures to respond to risks identified included the following:

- reviewing the financial statement disclosures and testing of supporting documentation to assess compliance with relevant laws and regulations described above as having a direct effect on the financial statements;
- enquiring of management, the Audit Committee, in-house legal counsel and, where necessary, circularising external legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing Internal Audit reports and reviewing correspondence with relevant tax authorities;
- obtaining a detailed understanding of and performing process walkthroughs in relation to the Group's process for engaging third parties to support business development, including testing a sample of these transactions;
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments;
- assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and
- evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists and significant component audit teams and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Companies Act 2006

In our opinion the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic report and the Directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the Group and of the Parent Company and their environment obtained in the course of the audit, we have not identified any material misstatements in the Strategic report or the Directors' report.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- 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 are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made or the part of the Directors' remuneration report to be audited is not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Other matters

Auditor tenure

Following the recommendation of the Audit Committee, we were appointed by the members on 10 May 2018 to audit the financial statements for the year ending 31 December 2018 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is two years.

Consistency of the audit report with the additional report to the Audit Committee

Our audit opinion is consistent with the additional report to the Audit Committee we are required to provide in accordance with ISAs (UK).

Use of our report

This report is made solely to the Parent Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Parent Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Parent Company and the Parent Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

John Adam
Senior Statutory Auditor

For and on behalf of
Deloitte LLP
Statutory Auditor

London, United Kingdom
19 February 2020

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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 90, 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 certain 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	The Group accounts for revenue in accordance with IFRS 15 Revenue from Contracts with Customers. For most of the Group's contracts, revenue and associated margin are recognised progressively over time as costs are incurred, and as risks have been mitigated or retired. The ultimate profitability of contracts is 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.	1
Carrying value of goodwill	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.	8
Deferred tax asset on post-employment benefit obligations	The Group has recognised a deferred tax asset in respect of the deficits in its pension/post-employment schemes. 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.	15
Tax provisions	Provision is made for known issues based on management's interpretation of country-specific legislation and management's assessment of 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 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.	17
Valuation of post-employment benefit obligations	Defined benefit pension scheme accounting valuations are prepared by independent actuaries. The liabilities of the pension schemes are valued based on a number of actuarial assumptions. For each of the actuarial assumptions used 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.	23

Preparation continued

Judgements made in applying accounting policies

In the course of preparing the financial statements, no judgements have been made in the process of applying the Group's accounting policies, other than those involving estimates, that have had a significant effect on the amounts recognised in the financial statements.

Sources of estimation uncertainty

The application of the Group's accounting policies requires the use of estimates. In the event that these estimates prove to be incorrect, there may be an adjustment to the carrying amounts of assets and liabilities within the next financial year. The key significant risks of a material adjustment to the carrying amounts of assets and liabilities during 2020 have been considered and assessed as relating to the following:

- The determination of the discount rate and inflation assumptions underpinning the valuation of the liabilities of the Group's defined benefit pension schemes, where there is a range of possible values for each of the actuarial assumptions and small changes in assumptions may have a significant impact on the size of the deficit. Note 23 provides information on the key assumptions and analysis of their sensitivities.
- Revenue and margin recognition on contracts is based on constraints on variable consideration, estimates of future costs and an assessment of technical and other risks, including geopolitical uncertainty such as the Group's inability to obtain or maintain the necessary export licences. The long-term nature of many of the Group's contracts means that judgements are made in estimating future costs on a contract as well as when risks will be mitigated or retired, which impacts when revenue and associated margin are recognised. As shown in note 1, the Group has recognised £0.3bn of revenue in both the current and prior financial year in respect of performance obligations satisfied or partially satisfied in previous periods. The Group currently considers that, based on the existing portfolio of contracts, this is a potential indicator of an amount up to which revenue may be recognised in the next 12 months relating to performance obligations already satisfied or partially satisfied.
- Tax provisioning is based on estimates of the potential outcomes of tax litigation or negotiations, the amount recorded being the single most likely amount in a range of possible outcomes. Such provisions can be difficult to estimate due to the complexity involved and the uncertainty in the process for their resolution. Note 17 provides information relating to potential material changes regarding tax provisions in the next financial year.

Changes in accounting policies

IFRS 16 Leases became effective from 1 January 2019. The impact of adoption is set out in note 36.

The following other standards, interpretations and amendments to existing standards became effective on 1 January 2019 and have not had a material impact on the Group:

- IFRIC 23 Uncertainty over Income Tax Treatments, effective from 1 January 2019;
- Amendments to IFRS 9: Prepayment Features with Negative Compensation, effective from 1 January 2019;
- Amendments to IAS 28: Long-term Interests in Associates and Joint Ventures, effective from 1 January 2019;
- Amendments to IAS 19: Plan Amendment, Curtailment or Settlement, effective from 1 January 2019; and
- Annual Improvements to IFRS Standards 2015–2017 Cycle, effective from 1 January 2019.

The following other standards, interpretations and amendments to existing standards have been issued but were not mandatory for accounting periods beginning on 1 January 2019 and are not expected to have a material impact on the Group:

- Amendments to References to the Conceptual Framework in IFRS Standards, effective 1 January 2020;
- Amendments to IAS 1 and IAS 8: Definition of Material, effective from 1 January 2020;
- Amendments to IFRS 9, IAS 39 and IFRS 7: Interest Rate Benchmark Reform, effective from 1 January 2020;
- Amendments to IFRS 3: Definition of a Business, effective from 1 January 2020 (not yet endorsed by the EU);
- IFRS 17 Insurance Contracts, effective from 1 January 2021 (not yet endorsed by the EU); and
- Amendments to IFRS 10 and IAS 28: Sale or contribution of assets between an investor and its associate or joint venture, effective date deferred indefinitely.

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	2019 £m	2019 Total £m	2018 £m	2018 Total £m
Continuing operations					
Sales	1	**20,109**		18,407	
Deduct Share of sales by equity accounted investments	1	**(2,878)**		(2,812)	
Add Sales to equity accounted investments	1	**1,074**		1,226	
Revenue	1		**18,305**		16,821
Operating costs	2		**(16,724)**		(15,514)
Other income	4		**150**		158
Group operating profit			**1,731**		1,465
Share of results of equity accounted investments	1		**168**		140
Underlying EBITA	1	**2,117**		1,928	
Non-recurring items	1	**(27)**		(154)	
EBITA		**2,090**		1,774	
Amortisation of intangible assets	1	**(109)**		(85)	
Impairment of intangible assets	1	**(6)**		(33)	
Financial expense of equity accounted investments	5	**(23)**		(13)	
Taxation expense of equity accounted investments	6	**(53)**		(38)	
Operating profit	1		**1,899**		1,605
Financial income[1]		**27**		26	
Financial expense[1]		**(300)**		(407)	
Net finance costs	5		**(273)**		(381)
Profit before taxation			**1,626**		1,224
Taxation expense	6		**(94)**		(191)
Profit for the year			**1,532**		1,033
Attributable to:					
Equity shareholders			**1,476**		1,000
Non-controlling interests			**56**		33
			1,532		1,033
Earnings per share	7				
Basic earnings per share			**46.4p**		31.3p
Diluted earnings per share			**46.1p**		31.2p

1. Gains on remeasurement of financial instruments at fair value through profit or loss and foreign exchange gains for the year ended 31 December 2018 have been reclassified to remove them from financial income and present all movements within financial expense. See note 5 for details.

Consolidated statement of comprehensive income for the year ended 31 December

	Notes	2019 Other reserves[1] £m	2019 Retained earnings £m	2019 Total £m	2018 Other reserves[1] £m	2018 Retained earnings £m	2018 Total £m
Profit for the year		**–**	**1,532**	**1,532**	–	1,033	1,033
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Subsidiaries:							
Remeasurements on post-employment benefit schemes		**–**	**(556)**	**(556)**	–	74	74
Tax on items that will not be reclassified to the income statement	6	**–**	**57**	**57**	–	5	5
Equity accounted investments (net of tax)		**–**	**(38)**	**(38)**	–	6	6
Items that may be reclassified to the income statement:							
Subsidiaries:							
Currency translation on foreign currency net investments		**(327)**	**–**	**(327)**	400	–	400
Reclassification of cumulative currency translation reserve on disposal		**(8)**	**–**	**(8)**	–	–	–
Fair value gain arising on hedging instruments during the period		**11**	**–**	**11**	14	–	14
Cumulative fair value gain on hedging instruments reclassified to the income statement		**(7)**	**–**	**(7)**	(39)	–	(39)
Tax on items that may be reclassified to the income statement	6	**–**	**–**	**–**	5	–	5
Equity accounted investments (net of tax)		**6**	**–**	**6**	15	–	15
Total other comprehensive income for the year (net of tax)		**(325)**	**(537)**	**(862)**	395	85	480
Total comprehensive income for the year		**(325)**	**995**	**670**	395	1,118	1,513
Attributable to:							
Equity shareholders		**(320)**	**940**	**620**	391	1,085	1,476
Non-controlling interests		**(5)**	**55**	**50**	4	33	37
		(325)	**995**	**670**	395	1,118	1,513

1. An analysis of other reserves is provided in note 25.

Consolidated statement of changes in equity for the year ended 31 December

	Notes	Attributable to equity holders of BAE Systems plc: Issued share capital £m	Share premium £m	Other reserves[1] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
Balance at 1 January 2019 as originally presented		87	1,249	6,481	(2,271)	5,546	72	5,618
Transition adjustment upon adoption of IFRS 16 Leases	36	–	–	–	(92)	(92)	–	(92)
Balance at 1 January 2019		87	1,249	6,481	(2,363)	5,454	72	5,526
Profit for the year		–	–	–	1,476	1,476	56	1,532
Total other comprehensive income for the year		–	–	(320)	(536)	(856)	(6)	(862)
Total comprehensive income for the year		–	–	(320)	940	620	50	670
Share-based payments (inclusive of tax)	30	–	–	–	75	75	–	75
Cumulative fair value gain on hedging instruments transferred to the balance sheet (net of tax)		–	–	(5)	–	(5)	–	(5)
Ordinary share dividends	25	–	–	–	(724)	(724)	(56)	(780)
Partial disposal of shareholding in subsidiary undertaking		–	–	–	(13)	(13)	38	25
At 31 December 2019		**87**	**1,249**	**6,156**	**(2,085)**	**5,407**	**104**	**5,511**
Balance at 1 January 2018		87	1,249	6,090	(2,714)	4,712	43	4,755
Profit for the year		–	–	–	1,000	1,000	33	1,033
Total other comprehensive income for the year		–	–	391	85	476	4	480
Total comprehensive income for the year		–	–	391	1,085	1,476	37	1,513
Share-based payments (inclusive of tax)	30	–	–	–	63	63	–	63
Net sale of own shares		–	–	–	1	1	–	1
Ordinary share dividends	25	–	–	–	(703)	(703)	(28)	(731)
Partial disposal of shareholding in subsidiary undertaking		–	–	–	(3)	(3)	20	17
At 31 December 2018		87	1,249	6,481	(2,271)	5,546	72	5,618

1. An analysis of other reserves is provided in note 25.

Consolidated balance sheet as at 31 December

	Notes	2019 £m	2018[1] £m
Non-current assets			
Intangible assets	8	**10,371**	10,658
Property, plant and equipment	9	**2,437**	2,365
Right-of-use assets	10	**1,138**	–
Investment property	11	**137**	98
Equity accounted investments	12	**428**	429
Other investments		**13**	13
Other receivables	13	**484**	352
Post-employment benefit surpluses	23	**302**	308
Other financial assets	14	**350**	245
Deferred tax assets	15	**726**	702
		16,386	15,170
Current assets			
Inventories	16	**835**	774
Trade, other and contract receivables	13	**5,458**	5,177
Current tax	17	**19**	81
Other financial assets	14	**210**	166
Cash and cash equivalents	18	**2,587**	3,232
Assets held for sale	19	**135**	146
		9,244	9,576
Total assets	20	**25,630**	24,746
Non-current liabilities			
Loans	21	**(3,020)**	(3,514)
Lease liabilities	10	**(1,116)**	–
Other payables	22	**(1,481)**	(1,461)
Post-employment benefit obligations	23	**(4,757)**	(4,337)
Other financial liabilities	14	**(227)**	(104)
Provisions	24	**(385)**	(427)
		(10,986)	(9,843)
Current liabilities			
Loans and overdrafts	21	**(377)**	(785)
Lease liabilities	10	**(238)**	–
Trade and other payables	22	**(7,926)**	(7,718)
Other financial liabilities	14	**(232)**	(74)
Current tax	17	**(55)**	(334)
Provisions	24	**(300)**	(334)
Liabilities held for sale	19	**(5)**	(40)
		(9,133)	(9,285)
Total liabilities		**(20,119)**	(19,128)
Net assets		**5,511**	5,618
Capital and reserves			
Issued share capital	25	**87**	87
Share premium		**1,249**	1,249
Other reserves	25	**6,156**	6,481
Retained earnings – deficit		**(2,085)**	(2,271)
Total equity attributable to equity holders of BAE Systems plc		**5,407**	5,546
Non-controlling interests		**104**	72
Total equity		**5,511**	5,618

1. The Saudi Arabia end of service benefit obligation of £97m at 31 December 2018 has been reclassified from trade and other payables to post-employment benefit obligations (see note 23).

Approved by the Board of BAE Systems plc on 19 February 2020 and signed on its behalf by:

C N Woodburn
Chief Executive

P J Lynas
Group Finance Director

Consolidated cash flow statement for the year ended 31 December

	Notes	2019 £m	2018[1] £m
Profit for the year		**1,532**	1,033
Taxation expense	6	**94**	191
Research and development expenditure credits	4	**(12)**	(27)
Share of results of equity accounted investments	1	**(168)**	(140)
Net finance costs	5	**273**	381
Depreciation, amortisation, impairment and derecognition	2	**660**	411
Gain on investment revaluation		**–**	(7)
Profit on disposal of property, plant and equipment, and investment property	2,4	**(9)**	(18)
(Gain)/loss in respect of held for sale assets and business disposals	2,4	**(9)**	9
Cost of equity-settled employee share schemes		**74**	64
Movements in provisions		**(73)**	(101)
Decrease in liabilities for post-employment benefit obligations		**(214)**	(153)
(Increase)/decrease in working capital:			
Inventories		**(76)**	(16)
Trade, other and contract receivables		**(481)**	(757)
Trade and other payables		**258**	530
Taxation paid		**(252)**	(200)
Net cash flow from operating activities		**1,597**	1,200
Dividends received from equity accounted investments	12	**142**	57
Interest received		**28**	25
Principal element of finance lease receipts		**9**	–
Purchase of property, plant and equipment, and investment property		**(360)**	(358)
Purchase of intangible assets		**(110)**	(139)
Proceeds from sale of property, plant and equipment, and investment property		**21**	34
Proceeds from sale of intangible assets		**1**	–
Purchase of equity accounted investment		**–**	(2)
Equity accounted investment funding	12	**(6)**	(1)
Purchase of subsidiary undertakings, net of cash and cash equivalents acquired	33	**(12)**	14
Cash flow in respect of held for sale assets and business disposals, net of cash and cash equivalents disposed		**55**	12
Net cash flow from investing activities		**(232)**	(358)
Interest paid		**(233)**	(203)
Net sale of own shares		**–**	1
Equity dividends paid	25	**(724)**	(703)
Dividends paid to non-controlling interests		**(56)**	(28)
Partial disposal of shareholding in subsidiary undertaking		**31**	17
Principal element of lease payments		**(239)**	–
Cash flow from matured derivative financial instruments (excluding cash flow hedges)		**40**	6
Cash flow from movement in cash collateral		**1**	2
Cash outflow from repayment of loans		**(782)**	(7)
Net cash flow from financing activities	27	**(1,962)**	(915)
Net decrease in cash and cash equivalents		**(597)**	(73)
Cash and cash equivalents at 1 January		**3,232**	3,264
Effect of foreign exchange rate changes on cash and cash equivalents		**(48)**	41
Cash and cash equivalents at 31 December		**2,587**	3,232

1. 2018 comparatives have been reclassified to present a cash inflow of £17m in respect of a partial disposal of the Group's shareholding in a subsidiary undertaking within financing activities. This cash flow was previously presented in investing activities.

1. Segmental analysis

Revenue and profit recognition
Revenue represents income derived from contracts for the provision of goods and services, over time or at a point in time, by the Group to customers in exchange for consideration in the ordinary course of the Group's activities.

Performance obligations
Upon approval by the parties to a contract, the contract is assessed to identify each promise to transfer either a distinct good or service or a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Goods and services are distinct and accounted for as separate performance obligations in the contract if the customer can benefit from them either on their own or together with other resources that are readily available to the customer and they are separately identifiable in the contract.

The Group provides warranties to its customers to give them assurance that its products and services will function in line with agreed-upon specifications. Warranties are not provided separately and, therefore, do not represent separate performance obligations.

Transaction price
At the start of the contract, the total transaction price is estimated as the amount of consideration to which the Group expects to be entitled in exchange for transferring the promised goods and services to the customer, excluding sales taxes. Variable consideration, such as price escalation, is included based on the expected value or most likely amount only to the extent that it is highly probable that there will not be a reversal in the amount of cumulative revenue recognised. The transaction price does not include estimates of consideration resulting from contract modifications, such as change orders, until they have been approved by the parties to the contract. The total transaction price is allocated to the performance obligations identified in the contract in proportion to their relative stand-alone selling prices. Given the bespoke nature of many of the Group's products and services, which are designed and/or manufactured under contract to the customer's individual specifications, there are typically no observable stand-alone selling prices. Instead, stand-alone selling prices are typically estimated based on expected costs plus contract margin consistent with the Group's pricing principles.

Whilst payment terms vary from contract to contract, on many of the Group's contracts, an element of the transaction price is received in advance of delivery. The Group therefore has significant contract liabilities (note 22). The Group's contracts are not considered to include significant financing components on the basis that there is no difference between the consideration and the cash selling price. UK Ministry of Defence contracting rules prohibit the inclusion of financing in the sales price. Negotiations on competitive international export contracts do not make allowance for the cash payment profile.

Revenue and profit recognition
Revenue is recognised as performance obligations are satisfied as control of the goods and services is transferred to the customer.

For each performance obligation within a contract, the Group determines whether it is satisfied over time or at a point in time. Performance obligations are satisfied over time if one of the following criteria is satisfied:

- the customer simultaneously receives and consumes the benefits provided by the Group's performance as it performs;
- the Group's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the Group's performance does not create an asset with an alternative use to the Group and it has an enforceable right to payment for performance completed to date.

The Group has determined that most of its contracts satisfy the over time criteria, either because the customer simultaneously receives and consumes the benefits provided by the Group's performance as it performs (typically services or support contracts) or the Group's performance does not create an asset with an alternative use to the Group and it has an enforceable right to payment for performance completed to date (typically development or production contracts).

For each performance obligation to be recognised over time, the Group recognises revenue using an input method, based on costs incurred in the period. Revenue and attributable margin are calculated by reference to reliable estimates of transaction price and total expected costs, after making suitable allowances for technical and other risks. Revenue and associated margin are therefore recognised progressively as costs are incurred, and as risks have been mitigated or retired. The Group has determined that this method appropriately depicts the Group's performance in transferring control of the goods and services to the customer.

If the over time criteria for revenue recognition are not met, revenue is recognised at the point in time that control is transferred to the customer, which is usually when legal title passes to the customer and the business has the right to payment, for example, on delivery.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

1. Segmental analysis continued

Software licences

The Group sells software licences either separately or together with other goods and services, including computer hardware and implementation, hosting and support. Revenue recognition in respect of software licences sold as part of a bundle of goods and services is considered separately when the licence is determined to be a separate performance obligation. Software licences either represent a right to access the Group's intellectual property as it exists throughout the licence period or a right to use the Group's intellectual property as it exists at the point in time at which the licence is granted. Revenue in respect of right to access licences is recognised over the licence term or, in relation to perpetual licences, over the related customer relationship and revenue in respect of right to use licences is recognised upfront on delivery to the customer. A software licence is considered to be a right to access the Group's intellectual property as it exists throughout the licence period if all of the following criteria are satisfied:

– the contract requires, or the customer reasonably expects, that the Group will undertake activities that significantly affect the intellectual property; and
– the licence directly exposes the customer to the effects of those activities; and
– those activities do not result in the transfer of a good or service to the customer.

Contract modifications

The Group's contracts are often amended for changes in customers' requirements and specifications. A contract modification exists when the parties to the contract approve a modification that either changes existing or creates new enforceable rights and obligations. The effect of a contract modification on the transaction price and the Group's measure of progress towards the satisfaction of the performance obligation to which it relates is recognised in one of the following ways:

1. prospectively, as an additional, separate contract;
2. prospectively, as a termination of the existing contract and creation of a new contract; or
3. as part of the original contract using a cumulative catch-up.

The majority of the Group's contract modifications are treated under either 1 (for example, the requirement for additional distinct goods or services) or 3 (for example, a change in the specification of the distinct goods or services for a partially completed contract), although the facts and circumstances of any contract modification are considered individually as the types of modifications will vary contract-by-contract and may result in different accounting outcomes.

Costs to obtain a contract

The Group expenses pre-contract bidding costs which are incurred regardless of whether a contract is awarded. The Group does not typically incur costs to obtain contracts that it would not have incurred had the contracts not been awarded, such as sales commission.

Costs to fulfil a contract

Contract fulfilment costs in respect of over time contracts are expensed as incurred. Contract fulfilment costs in respect of point in time contracts are accounted for under IAS 2 Inventories.

Reporting segments

The Group has the following six reporting segments:

– **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, precision guidance and seeker solutions, 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),** with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including ship repair, and the management and operation of government-owned munitions facilities;
– **Air** comprises the Group's UK-based air activities for European and International Markets, and US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture;
– **Maritime** comprises the Group's UK-based maritime and land activities; and
– **HQ** comprises the Group's head office and UK-based shared services 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 167) and underlying EBITA (see page 168). Finance costs and taxation expense are managed on a Group basis.

1. Segmental analysis continued

Key Performance Indicator – Sales
Definition Revenue plus 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	
	2019 £m	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m
Electronic Systems	**4,439**	3,965	**(114)**	(101)	**114**	101	**4,439**	3,965
Cyber & Intelligence	**1,732**	1,678	**–**	–	**–**	–	**1,732**	1,678
Platforms & Services (US)	**3,337**	3,005	**(153)**	(141)	**1**	–	**3,185**	2,864
Air	**7,457**	6,712	**(2,221)**	(2,224)	**917**	1,091	**6,153**	5,579
Maritime	**3,116**	2,975	**(50)**	(37)	**5**	2	**3,071**	2,940
HQ	**387**	350	**(344)**	(309)	**–**	–	**43**	41
	20,468	18,685	**(2,882)**	(2,812)	**1,037**	1,194	**18,623**	17,067
Intra-group sales/revenue	**(359)**	(278)	**4**	–	**37**	32	**(318)**	(246)
	20,109	18,407	**(2,878)**	(2,812)	**1,074**	1,226	**18,305**	16,821

	Intra-group revenue		Revenue from external customers	
	2019 £m	2018 £m	**2019 £m**	2018 £m
Electronic Systems	**89**	54	**4,350**	3,911
Cyber & Intelligence	**102**	91	**1,630**	1,587
Platforms & Services (US)	**43**	39	**3,142**	2,825
Air	**12**	10	**6,141**	5,569
Maritime	**62**	40	**3,009**	2,900
HQ	**10**	12	**33**	29
	318	246	**18,305**	16,821

Sales and revenue by customer location

	Sales		Revenue	
	2019 £m	2018 £m	**2019 £m**	2018 £m
UK	**3,850**	3,819	**3,681**	3,622
Rest of Europe[1]	**2,095**	2,007	**1,156**	1,176
US	**8,642**	7,729	**8,635**	7,713
Canada	**129**	115	**129**	115
Saudi Arabia	**2,693**	2,593	**2,593**	2,464
Rest of Middle East	**1,180**	801	**992**	694
Australia	**667**	562	**667**	560
Rest of Asia and Pacific	**564**	636	**423**	430
Africa, and Central and South America	**289**	145	**29**	47
	20,109	18,407	**18,305**	16,821

1. Includes £0.6bn (2018 £0.7bn) generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

Revenue from external customers by domain

	2019					2018				
	Air £m	**Maritime £m**	**Land £m**	**Cyber £m**	**Total £m**	Air £m	Maritime £m	Land £m	Cyber £m	Total £m
Electronic Systems	**3,502**	**109**	**739**	**–**	**4,350**	3,105	151	655	–	3,911
Cyber & Intelligence	**219**	**412**	**93**	**906**	**1,630**	246	371	132	838	1,587
Platforms & Services (US)	**42**	**1,196**	**1,904**	**–**	**3,142**	32	1,187	1,606	–	2,825
Air	**5,557**	**413**	**171**	**–**	**6,141**	5,136	290	143	–	5,569
Maritime	**–**	**2,774**	**235**	**–**	**3,009**	16	2,623	261	–	2,900
HQ	**33**	**–**	**–**	**–**	**33**	29	–	–	–	29
	9,353	**4,904**	**3,142**	**906**	**18,305**	8,564	4,622	2,797	838	16,821

1. Segmental analysis continued

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2019 £m	2018 £m
US Department of Defense	**6,547**	5,148
UK Ministry of Defence[1]	**3,868**	3,848
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**2,541**	2,366

1. Includes £0.6bn (2018 £0.7bn) 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 Air and Maritime reporting segments.

Key Performance Indicator – Underlying EBITA

Definition Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items.

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

Amortisation and impairment of intangible assets are excluded because they are not related to the in-year operational performance of the business, being driven by the timing and amount of investment in acquired businesses and software.

Finance costs and taxation expense of equity accounted investments are excluded for consistency with pre-interest, pre-tax business performance.

Non-recurring items are items of financial performance which have been determined by management as being material by their size or incidence and not relevant to an understanding of the Group's underlying business performance. The Group's definition of non-recurring items includes profit or loss on business transactions, and costs incurred which are one-off in nature, for example non-routine costs or income relating to post-retirement benefit schemes, and other exceptional items which management has determined as not being relevant to an understanding of the Group's underlying business performance.

2019

Non-recurring items of £27m comprises a £36m charge relating to the derecognition of Enterprise Resource Planning software intangible assets in the Air sector, charges of £13m relating to legal disputes arising from historical disposals, a gain of £14m on the sale of the Group's 55% shareholding in BAE Systems Global Combat Systems Limited upon formation of the Rheinmetall BAE Systems Land joint venture, and a gain of £8m relating to the disposal of Aircraft Accessories and Components Company.

2018

Non-recurring items of £154m represented a Guaranteed Minimum Pension equalisation charge of £114m, and a loss on disposal of the Mobile, Alabama, shipyard of £40m.

Operating profit/(loss) by reporting segment

	Underlying EBITA		Non-recurring items		Amortisation and impairment of intangible assets		Financial and taxation expense of equity accounted investments		Operating profit/(loss)	
	2019 £m	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m
Electronic Systems	**687**	606	**–**	–	**(15)**	(16)	**–**	–	**672**	590
Cyber & Intelligence	**91**	111	**–**	–	**(11)**	(52)	**–**	–	**80**	59
Platforms & Services (US)	**267**	210	**(13)**	(40)	**(11)**	(8)	**(4)**	(1)	**239**	161
Air	**887**	859	**(28)**	–	**(32)**	(12)	**(50)**	(37)	**777**	810
Maritime	**268**	209	**14**	–	**(25)**	(16)	**(4)**	(2)	**253**	191
HQ	**(83)**	(67)	**–**	(114)	**(21)**	(14)	**(18)**	(11)	**(122)**	(206)
	2,117	1,928	**(27)**	(154)	**(115)**	(118)	**(76)**	(51)	**1,899**	1,605
Net finance costs									**(273)**	(381)
Profit before taxation									**1,626**	1,224
Taxation expense									**(94)**	(191)
Profit for the year									**1,532**	1,033

1. Segmental analysis continued

Share of results of equity accounted investments within reporting segments

	Underlying EBITA		Non-recurring items		Amortisation of intangible assets		Financial and taxation expense		Share of results of equity accounted investments	
	2019 £m	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m
Electronic Systems	**5**	9	**–**	–	**–**	–	**–**	–	**5**	9
Platforms & Services (US)	**21**	23	**–**	–	**(1)**	–	**(4)**	(1)	**16**	22
Air	**188**	150	**–**	–	**(7)**	(7)	**(50)**	(37)	**131**	106
Maritime	**8**	7	**–**	–	**–**	–	**(4)**	(2)	**4**	5
HQ	**30**	13	**–**	(4)	**–**	–	**(18)**	(11)	**12**	(2)
	252	202	**–**	(4)	**(8)**	(7)	**(76)**	(51)	**168**	140

Key Performance Indicator – Order backlog

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.

Performance obligations

The Group's order book[1], reconciled to order backlog as defined by the Group, is shown below.

	2019 £bn	2018 £bn
Order backlog as defined by the Group	**45.4**	48.4
Deduct Unfunded order backlog	**(2.2)**	(2.0)
Deduct Share of order backlog of equity accounted investments	**(9.2)**	(9.9)
Add Order backlog in respect of orders from equity accounted investments	**3.2**	3.3
Order book[1]	**37.2**	39.8

1. Order book represents the transaction price allocated to unsatisfied and partially satisfied performance obligations as defined by IFRS 15 Revenue from Contracts with Customers.

The Group expects that approximately 40% (2018 35%) of the order book will be recognised as revenue during the next year, with the remainder largely recognised over the following four (2018 four) years.

For each performance obligation to be recognised over time, the Group recognises revenue using an input method, based on costs incurred in the period. Revenue and attributable margin are calculated by reference to reliable estimates of transaction price and total expected costs, after making suitable allowances for technical and other risks. Revenue and associated margin are therefore recognised progressively as costs are incurred, and as risks have been mitigated or retired. The Group has determined that this method appropriately depicts the Group's performance in transferring control of the goods and services to the customer. Accordingly, revenue of £0.3bn (2018 £0.3bn) was recognised during the year in respect of performance obligations satisfied or partially satisfied in previous periods.

2. Operating costs

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 recognised in the income statement in accordance with the Group's revenue recognition policy.

	2019 £m	2018 £m
Raw materials, subcontracts and other bought-in items used	**6,448**	5,816
Change in inventories of finished goods and work-in-progress	**(20)**	44
Staff costs (note 3)	**6,417**	5,876
Guaranteed Minimum Pension equalisation charge (note 23)	**–**	110
Depreciation[1]	**511**	269
Amortisation	**101**	78
Impairment – property, plant and equipment (note 9), and right of use assets (note 10)	**6**	31
Impairment – intangible assets (note 8)	**6**	33
Derecognition – intangible assets (note 8)	**36**	–
Operating lease expense[2]	**–**	287
Loss on disposal of property, plant and equipment, and investment property	**1**	1
Loss in respect of held for sale assets and business disposals	**13**	9
Other operating charges	**3,205**	2,960
Operating costs	**16,724**	15,514

1. 2019 includes £217m of depreciation of right-of-use assets recognised under IFRS 16 Leases, which became effective on 1 January 2019 (see note 10).
2. Operating lease expense is no longer applicable under IFRS 16 Leases, which became effective on 1 January 2019. Amounts recognised in the income statement in respect of leases for 2019 are disclosed in note 10.

Operating costs includes research and development expenditure of £224m (2018 £212m) funded by the Group. Development investment of £13m (2018 £10m) was capitalised during the year (see note 8).

Fees payable to the Company's auditor and its associates included in operating costs

	2019			2018		
	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	**2,032**	**–**	**2,032**	2,000	–	2,000
Fees payable to the Company's auditor and its associates for other services to the Group:						
The audit of the Company's subsidiaries	**3,082**	**4,624**	**7,706**	2,687	4,091	6,778
Total audit fees	**5,114**	**4,624**	**9,738**	4,687	4,091	8,778
Audit-related assurance services[1]	**655**	**422**	**1,077**	690	–	690
Other assurance services	**–**	**–**	**–**	175	–	175
Other services[2]	**–**	**–**	**–**	1,776	–	1,776
Total non-audit fees	**655**	**422**	**1,077**	2,641	–	2,641
Total fees payable to the Company's auditor and its associates	**5,769**	**5,046**	**10,815**	7,328	4,091	11,419

1. Audit-related assurance services comprises fees in respect of the review of the Group's Half-yearly Report and fees in respect of the audit of BAE Systems pension schemes.
2. Other services in 2018 primarily related to consultancy work in relation to the Group's Submarines business.

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	
	2019 Number '000	2018 Number '000	**2019 Number '000**	2018 Number '000
Electronic Systems	**16**	15	**16**	16
Cyber & Intelligence	**10**	10	**10**	10
Platforms & Services (US)	**12**	11	**12**	11
Air	**23**	22	**23**	23
Maritime	**16**	16	**16**	16
HQ	**2**	2	**2**	2
	79	76	**79**	78

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2019 £m	2018 £m
Wages and salaries[1]	**5,505**	5,019
Social security costs	**402**	367
Share-based payments (note 30)	**74**	63
Pension costs – defined contribution plans (note 23)	**226**	203
Pension costs – defined benefit plans (note 23)	**192**	223
Other post-employment benefit costs (note 23)	**18**	1
	6,417	5,876

1. After excluding the impact of exchange translation, wages and salaries increased by approximately 3% per employee in 2019.

4. Other income

Leases
Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

	2019 £m	2018 £m
Research and development expenditure credits	**12**	27
Operating lease income from investment property	**28**	22
Operating lease income from subleasing right-of-use assets	**1**	–
Other operating lease income	**–**	15
Profit on disposal of businesses	**22**	–
Profit on disposal of property, plant and equipment	**–**	13
Profit on disposal of investment property	**10**	6
Management recharges to equity accounted investments (note 31)	**19**	18
Royalties	**11**	11
Other[1]	**47**	46
Other income	**150**	158

1. Includes £15m (2018 £15m) for capital spend recovery in respect of Saudi Arabia Industrial Participation investments and a £7m (2018 £8m) recovery of site development costs for the Dreadnought programme in Barrow.

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.

	2019 £m	2018 £m
Interest income on cash and other financial instruments	**26**	26
Interest income on finance lease receivables (note 10)	**1**	–
Financial income[1]	**27**	26
Interest expense on bonds and other financial instruments	**(187)**	(204)
Facility fees	**(4)**	(4)
Interest expense on lease liabilities (note 10)	**(48)**	–
Net present value adjustments on provisions and other payables	**(28)**	(31)
Net interest expense on post-employment benefit obligations (note 23)	**(114)**	(103)
(Loss)/gain on remeasurement of financial instruments at fair value through profit or loss[2]	**(73)**	146
Foreign exchange gains/(losses)[3]	**154**	(211)
Financial expense[1]	**(300)**	(407)
Net finance costs	**(273)**	(381)

1. Gains on remeasurement of financial instruments at fair value through profit or loss of £186m and foreign exchange gains of £16m were previously presented within financial income in 2018. The Group believes it is more representative to present these items net within financial expense, since the gains and losses relate to the same underlying transactions. Accordingly, amounts previously included within financial income in 2018 have been reclassified to financial expense.
2. 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.
3. The foreign exchange gains and losses primarily reflect exchange rate movements on US dollar-denominated borrowings.

Additional analysis

	2019 £m	2018 £m
Net finance costs:		
Group	**(273)**	(381)
Share of equity accounted investments	**(23)**	(13)
	(296)	(394)
Analysed as:		
Underlying net interest expense[1]:		
Group	**(240)**	(213)
Share of equity accounted investments	**(17)**	(2)
	(257)	(215)
Other:		
Group:		
Net interest expense on post-employment benefit obligations	**(114)**	(103)
Fair value and foreign exchange adjustments on financial instruments and investments[2]	**81**	(65)
Share of equity accounted investments:		
Net interest expense on post-employment benefit obligations	**(3)**	(3)
Fair value and foreign exchange adjustments on financial instruments and investments	**(3)**	(8)
	(296)	(394)

1. Underlying net interest expense is defined as finance costs for the Group and its share of equity accounted investments, excluding net interest expense on post-employment benefit obligations and fair value and foreign exchange adjustments on financial instruments and investments.
2. The net gain (2018 loss) primarily reflects foreign exchange translational gains (2018 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

	2019 £m	2018 £m
Current taxation		
UK:		
Current year	**(91)**	(64)
Adjustments in respect of prior years	**(89)**	(2)
	(180)	(66)
Overseas:		
Current year	**(208)**	(183)
Adjustments in respect of prior years	**297**	42
	89	(141)
Total current taxation	**(91)**	(207)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	**3**	15
Adjustments in respect of prior years	**(3)**	15
Tax rate adjustment	**(1)**	–
	(1)	30
Overseas:		
Origination and reversal of temporary differences	**11**	(1)
Adjustments in respect of prior years	**(13)**	(18)
Tax rate adjustment	**–**	5
	(2)	(14)
Total deferred taxation	**(3)**	16
Taxation expense	**(94)**	(191)
UK	**(181)**	(36)
Overseas	**87**	(155)
Taxation expense	**(94)**	(191)

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.

	2019 £m	2018 £m
Profit before taxation	**1,626**	1,224
UK corporation tax rate	**19%**	19%
Expected income tax expense	**(309)**	(233)
Effect of tax rates in foreign jurisdictions, including US state taxes	**(52)**	(43)
Effect of intra-group financing	**–**	14
Expenses not tax effected	**(14)**	(14)
Income not subject to tax	**61**	18
Research and development tax credits and patent box benefits	**10**	14
Non-taxable non-recurring items	**4**	–
Chargeable gains	**(3)**	(1)
Utilisation of previously unrecognised tax losses	**3**	1
Current year losses not tax effected	**(3)**	–
Adjustments in respect of prior years	**192**	37
Adjustments in respect of equity accounted investments	**32**	27
Tax rate adjustment	**(1)**	5
Other	**(14)**	(16)
Taxation expense	**(94)**	(191)

Calculation of the underlying effective tax rate

	2019 £m	2018 £m
Profit before taxation	**1,626**	1,224
Add back: Taxation expense of equity accounted investments	**53**	38
Deduct: Non-taxable non-recurring items	**(22)**	–
Adjusted profit before taxation	**1,657**	1,262
Taxation expense	**(94)**	(191)
Taxation expense of equity accounted investments	**(53)**	(38)
Exclude: One-off tax benefit	**(161)**	–
Adjusted taxation expense (including equity accounted investments)	**(308)**	(229)
Underlying effective tax rate	**19%**	18%

The one-off tax benefit relates to two items. Firstly, following agreements reached in respect of overseas tax matters, a benefit has been recognised. Secondly, following review of the April 2019 EU Commission decision that concluded that the UK's Controlled Foreign Company regime partially represents State Aid, a provision has been recognised for the estimated exposure. There remains uncertainty surrounding HMRC's likely approach to the assessment of the deemed State Aid and recovery of amounts which they consider to be due, and, accordingly, developments will continue to be monitored and assessed.

6. Taxation expense continued

Tax recognised in other comprehensive income

	2019			2018		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
Items that will not be reclassified to the income statement:						
Subsidiaries:						
Remeasurements on post-employment benefit schemes	**(556)**	**76**	**(480)**	74	3	77
Tax rate adjustment	**–**	**(19)**	**(19)**	–	2	2
Equity accounted investments	**(52)**	**14**	**(38)**	8	(2)	6
Items that may be reclassified to the income statement:						
Subsidiaries:						
Currency translation on foreign currency net investments	**(327)**	**–**	**(327)**	400	–	400
Reclassification of cumulative currency translation reserve on disposal	**(8)**	**–**	**(8)**	–	–	–
Fair value gain arising on hedging instruments during the period	**11**	**(2)**	**9**	14	(3)	11
Cumulative fair value gain on hedging instruments reclassified to the income statement	**(7)**	**2**	**(5)**	(39)	8	(31)
Equity accounted investments	**12**	**(6)**	**6**	16	(1)	15
	(927)	**65**	**(862)**	473	7	480

	2019			2018		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Subsidiaries:						
Remeasurements on post-employment benefit schemes	**–**	**28**	**28**	–	24	24
	–	**28**	**28**	–	24	24
Deferred tax						
Subsidiaries:						
Remeasurements on post-employment benefit schemes	**–**	**48**	**48**	–	(21)	(21)
Tax rate adjustment	**–**	**(19)**	**(19)**	–	2	2
Fair value gain arising on hedging instruments during the period	**(2)**	**–**	**(2)**	(3)	–	(3)
Cumulative fair value gain on hedging instruments reclassified to the income statement	**2**	**–**	**2**	8	–	8
Equity accounted investments	**(6)**	**14**	**8**	(1)	(2)	(3)
	(6)	**43**	**37**	4	(21)	(17)
Tax on other comprehensive income	**(6)**	**71**	**65**	4	3	7

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.

Amortisation and impairment of intangible assets are excluded because they are not related to the in-year operational performance of the business, being driven by the timing and quantum of investment in acquired businesses and software.

Non-cash finance movements on pensions are excluded because they are driven by external factors, such as corporate bond yields and inflation.

Non-cash finance movements on financial derivatives are excluded because they are driven by external factors, such as foreign exchange rates and interest rates.

Non-recurring items (as defined in note 1) are items of financial performance which have been determined by management as being material by their size or incidence and not relevant to an understanding of the Group's underlying performance.

	2019			2018		
	£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	**1,476**	**46.4**	**46.1**	1,000	31.3	31.2
Add back/(deduct):						
Amortisation and impairment of intangible assets, post tax[1]	**93**			97		
Net interest expense on post-employment benefit obligations, post tax[1]	**95**			87		
Fair value and foreign exchange adjustments on financial instruments and investments, post tax[1]	**(64)**			60		
Non-recurring items, post tax[1]	**18**			126		
Underlying earnings, post tax	**1,618**	**50.8**	**50.5**	1,370	42.9	42.8
One-off tax benefit	**(161)**			–		
Underlying earnings, excluding one-off tax benefit	**1,457**	**45.8**	**45.5**	1,370	42.9	42.8
		Millions	**Millions**		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		**3,183**	**3,183**		3,192	3,192
Incremental shares in respect of employee share schemes			**18**			9
Weighted average number of shares used in calculating diluted earnings per share			**3,201**			3,201

1. The tax impact is calculated using the underlying effective tax rate of 19% (2018 18%). The calculation of the underlying effective tax rate is shown in note 6.

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.

Software

Software includes:

- **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; and
- **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.

Development costs

Development costs funded by the Group on activities applied to a plan or design for the production of new or substantially improved products are capitalised as an internally-generated intangible asset if certain conditions are met. The costs capitalised include materials, direct labour and related overheads.

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. These assets are initially recognised at their fair value at the acquisition date.

Other

Other intangible assets includes 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:

Software	up to 5 years
Development costs	up to 10 years
Programme and customer-related	up to 15 years
Other	up to 20 years

The Group has no indefinite-life intangible assets other than goodwill.

Impairment of intangible assets, property, plant and equipment, right-of-use assets, investment property and equity accounted investments

The carrying amounts of the Group's intangible assets (excluding goodwill), property, plant and equipment, right-of-use assets, 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 (CGU) 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 CGU 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.

8. Intangible assets continued

	Goodwill £m	Software £m	Development costs £m	Programme and customer-related £m	Other £m	Total £m
Cost or valuation						
At 1 January 2018	14,722	647	90	265	89	15,813
Additions:						
Acquired separately	–	98	–	5	2	105
Internally developed	–	28	10	–	–	38
Disposals[1]	–	(16)	–	(43)	(2)	(61)
Reclassification as held for sale	(80)	(10)	–	–	–	(90)
Net transfer from property, plant and equipment	–	13	–	–	–	13
Foreign exchange adjustments	436	15	5	9	4	469
At 31 December 2018	15,078	775	105	236	93	16,287
Additions:						
Acquired separately	–	67	–	–	9	76
Internally developed	–	18	13	–	–	31
Business acquisitions	30	–	–	1	3	34
Derecognition	–	(36)	–	–	–	(36)
Disposals[1]	–	(79)	(7)	(1)	(65)	(152)
Reclassification as held for sale	(48)	(8)	–	(60)	–	(116)
Transfer from property, plant and equipment	–	19	–	–	–	19
Foreign exchange adjustments	(320)	(13)	(5)	(9)	(2)	(349)
At 31 December 2019	**14,740**	**743**	**106**	**167**	**38**	**15,794**
Amortisation and impairment						
At 1 January 2018	4,726	322	62	240	85	5,435
Amortisation[2]	–	63	7	11	3	84
Impairment charge[3]	–	–	–	33	–	33
Disposals[1]	–	(16)	–	(43)	(2)	(61)
Transfer to property, plant and equipment	–	(3)	–	–	–	(3)
Reclassification as held for sale	–	(3)	–	–	–	(3)
Reclassification between categories	–	23	–	(23)	–	–
Foreign exchange adjustments	113	14	4	9	4	144
At 31 December 2018	4,839	400	73	227	90	5,629
Amortisation[2]	–	87	10	5	5	107
Impairment charge	–	6	–	–	–	6
Disposals[1]	–	(78)	(7)	(1)	(65)	(151)
Reclassification as held for sale	–	(8)	–	(60)	–	(68)
Transfer from property, plant and equipment	–	9	–	–	–	9
Foreign exchange adjustments	(83)	(12)	(4)	(8)	(2)	(109)
At 31 December 2019	**4,756**	**404**	**72**	**163**	**28**	**5,423**
Net book value						
At 31 December 2019	**9,984**	**339**	**34**	**4**	**10**	**10,371**
At 31 December 2018	10,239	375	32	9	3	10,658
At 1 January 2018	9,996	325	28	25	4	10,378

1. Includes intangible assets with nil net book value no longer used by the Group.
2. Amortisation of £107m (2018 £84m) includes £101m (2018 £78m) charged to the income statement as an amortisation expense and £6m (2018 £6m) recoverable on customer contracts.
3. The impairment charge for 2018 in Cyber & Intelligence related to Silversky customer-related intangible assets.

8. Intangible assets continued

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 of 2% applied for each significant Cash-Generating Unit (CGU). 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 6.62% (2018 7.24%) (adjusted for risks specific to the market in which the CGU operates), have been used in discounting these projected risk-adjusted cash flows.

Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £8.0bn (2018 £8.2bn) 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	**2019 £bn**	2018 £bn	**2019 %**	2018 %
Electronic Systems	Continued demand from the US government for electronic warfare systems (where the business has a leadership position), other technology-based solutions and growth in the commercial avionics market	**3.9**	4.0	**8**	9
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**	0.7	**8**	9
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	**3.4**	3.5	**8**	9

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2019 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% and 2% 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		Headroom assuming a 2% increase in the discount rate	
Cash-Generating Unit	**2019 £bn**	2018 £bn	**2019 £bn**	2018 £bn	**2019 £bn**	2018 £bn	**2019 £bn**	2018 £bn
Electronic Systems	**5.7**	4.4	**4.1**	3.0	**3.8**	2.8	**2.5**	1.6
Intelligence & Security	**0.9**	0.7	**0.7**	0.5	**0.6**	0.5	**0.5**	0.4
Platforms & Services (US)	**2.2**	1.8	**1.3**	0.9	**1.1**	0.8	**0.4**	0.1

Other CGUs

The remaining goodwill balance of £2.0bn (2018 £2.0bn) is allocated across multiple CGUs, including £0.2bn (2018 £0.2bn) 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.

Software

The software intangible net book value balance includes £85m (2018 £135m) relating to an Enterprise Resource Planning transformation programme which went live across the Air segment during the year. The remaining amortisation period is four years.

Capital commitments

At 31 December 2019, capital expenditure of £16m (2018 £21m) in respect of intangible assets was contracted for but not provided for in the accounts.

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 way of a government grant 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

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 2018	2,212	3,232	5,444
Additions[1]	154	288	442
Reclassification as held for sale	(11)	(12)	(23)
Transfer (to)/from intangible assets	(17)	4	(13)
Reclassification between categories	44	(60)	(16)
Disposals	(117)	(141)	(258)
Foreign exchange adjustments	50	87	137
At 31 December 2018	2,315	3,398	5,713
Additions[1]	199	238	437
Reclassification as held for sale	(37)	(25)	(62)
Transfer to intangible assets	–	(19)	(19)
Reclassification between categories	(14)	23	9
Disposals	(21)	(108)	(129)
Foreign exchange adjustments	(48)	(72)	(120)
At 31 December 2019	**2,394**	**3,435**	**5,829**
Depreciation and impairment			
At 1 January 2018	1,083	2,131	3,214
Depreciation charge for the year	84	183	267
Impairment charge for the year	27	4	31
Reclassification as held for sale	(7)	(6)	(13)
Transfer from intangible assets	–	3	3
Reclassification between categories	18	(34)	(16)
Disposals	(89)	(136)	(225)
Foreign exchange adjustments	29	58	87
At 31 December 2018	1,145	2,203	3,348
Depreciation charge for the year	87	199	286
Impairment charge for the year	2	1	3
Reclassification as held for sale	(21)	(22)	(43)
Transfer to intangible assets	–	(9)	(9)
Reclassification between categories	(13)	22	9
Disposals	(19)	(105)	(124)
Foreign exchange adjustments	(28)	(50)	(78)
At 31 December 2019	**1,153**	**2,239**	**3,392**
Net book value			
At 31 December 2019	**1,241**	**1,196**	**2,437**
At 31 December 2018	1,170	1,195	2,365
At 1 January 2018	1,129	1,101	2,230

1. Includes £93m (2018 £70m) of land and buildings, and £nil (2018 £20m) of plant and machinery at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

9. Property, plant and equipment continued

Net impairment

	2019 £m	2018 £m
Electronic Systems	**2**	–
Platforms & Services (US)	**1**	31
	3	31

2019
The impairment charge in Electronic Systems relates to building structural issues in Austin, Texas.

2018
The impairment charge in Platforms & Services (US) related to the Mobile shipyard prior to its disposal.

Assets in the course of construction

	Land and buildings[1] £m	Plant and machinery £m	Total £m
At 31 December 2019	**313**	**214**	**527**
At 31 December 2018	198	230	428

1. Includes £210m (2018 £129m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

Capital commitments
At 31 December 2019, capital expenditure of £205m (2018 £243m) in respect of property, plant and equipment was contracted for but not provided for in the accounts.

10. Leases

The Group as lessee
All leases in which the Group is lessee (except as noted below) are recognised as a right-of-use asset and a corresponding lease liability at the date at which the leased asset is available for use by the Group. Each lease payment is allocated between repayment of the lease liability and finance cost. The finance cost is charged to the income statement over the lease term to produce a constant periodic rate of interest on the lease liability. The right-of-use asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

The lease liability is initially measured as the present value of future lease payments, discounted using the interest rate implicit in the lease. Where this rate is not determinable, the Group's incremental borrowing rate is used, which is the interest rate the Group would have to pay to borrow the amount necessary to obtain an asset of similar value, in a similar economic environment with similar terms and conditions.

The right-of-use asset is initially measured at cost, comprising the initial value of the lease liability, any lease payments made (net of any incentives received from the lessor) before the commencement of the lease, any initial direct costs and any restoration costs.

The carrying amounts of the Group's right-of-use assets 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.

Payments in respect of short-term leases, low-value leases and leases of intangible assets are charged to the income statement on a straight-line basis over the lease term.

The Group as lessor
Leases in which the Group is lessor are classified as finance leases or operating leases. If the lease transfers substantially all of the risks and rewards of ownership to the lessee, the lease is classified as a finance lease. All other leases are classified as operating leases.

A sublease where the Group is an intermediate lessor is classified as a finance lease when it transfers substantially all of the risks and rewards of the right-of-use asset arising from the head lease.

Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

Amounts due from lessees under finance leases are recognised as a receivable discounted at the interest rate implicit in the lease. Finance lease income is recognised in the income statement over the lease term to produce a constant periodic rate of interest on the receivable.

IFRS 16 Leases became effective from 1 January 2019. The impact of adoption is set out in note 36.

The Group leases land, buildings, vehicles and equipment under non-cancellable lease arrangements. 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.

10. Leases continued

Right-of-use assets

	31 December 2019		
	Land and buildings £m	Plant and machinery £m	Total £m
Additions during the year	129	9	138
Depreciation expense for the year	207	10	217
Impairment charge for the year	3	–	3
Net book value	1,120	18	1,138

Lease liabilities

A maturity analysis of the future undiscounted lease payments in respect of the Group's lease liabilities is presented in the table below:

	2019 £m
Payments due:	
Within one year	297
Between one and five years	710
Later than five years	566
	1,573

The Group is also committed to future undiscounted lease payments of £84m in respect of leases which had not yet commenced at 31 December 2019.

The total cash outflow for leases in the year ended 31 December 2019, including short-term leases and low-value leases, amounted to £317m.

Amounts recognised in the income statement

	2019 £m
Included in operating costs:	
Depreciation on right-of-use assets	(217)
Short-term lease expense	(30)
Low-value lease expense	(5)
	(252)
Included in other income:	
Operating lease income from investment property	28
Operating lease income from subleasing right-of-use assets	1
	29
Included in net finance costs:	
Interest income on finance lease receivables	1
Interest expense on lease liabilities	(48)
	(47)

10. Leases continued

Operating leases

The Group is party to operating leases in which it is the lessor, primarily relating to investment property. 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.

A maturity analysis of the future undiscounted lease receipts from operating leases in which the Group is lessor is presented in the table below:

	2019 £m
Receipts due:	
Within one year	**28**
Between one and two years	**25**
Between two and three years	**24**
Between three and four years	**23**
Between four and five years	**22**
Later than five years	**3**
	125

	2018 £m
Receipts due:	
Within one year	24
Between one and five years	95
Later than five years	28
	147

Finance lease receivables

From 1 January 2019, certain of the Group's subleases where the Group is an intermediate lessor are now classified as finance leases under IFRS 16. A sublease is classified as a finance lease when it transfers substantially all of the risks and rewards of the right-of-use asset arising from the head lease. The Group did not have any leases classified as finance leases in 2018 before the adoption of IFRS 16.

A maturity analysis of the future undiscounted lease receipts from finance leases in which the Group is lessor is presented in the table below:

	2019 £m
Receipts due:	
Within one year	**11**
Between one and two years	**11**
Between two and three years	**11**
Between three and four years	**10**
Between four and five years	**10**
Later than five years	**15**
Total undiscounted gross receipts	**68**
Deduct: Impact of discounting	**(5)**
Finance lease receivables (note 13)	**63**

11. 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 2018	161
Additions	8
Disposals	(9)
At 31 December 2018	160
Cost recognised on transition to IFRS 16 (note 36)	45
Additions	15
Disposals	(11)
At 31 December 2019	**209**
Depreciation and impairment	
At 1 January 2018	60
Depreciation charge for the year	2
At 31 December 2018	62
Impairment recognised on transition to IFRS 16 (note 36)	2
Depreciation charge for the year	8
At 31 December 2019	**72**
Net book value	
At 31 December 2019	**137**
At 31 December 2018	98
At 1 January 2018	101

Fair value	
At 31 December 2019	**222**
At 31 December 2018	176

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.

Capital commitments
At 31 December 2019, capital expenditure of £45m (2018 £10m) in respect of investment property was contracted for but not provided for in the accounts.

12. Equity accounted investments

Equity accounted investments comprises joint ventures and associates. A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets of the arrangement. An associate is an entity over which the Group has significant influence.

The Group recognises its share of the profit or loss and other comprehensive income of equity accounted investments as a separate line in the Consolidated income statement and Consolidated statement of comprehensive income, respectively.

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 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.

	2019		2018	
	Eurofighter Jagdflugzeug £m	**MBDA £m**	Eurofighter Jagdflugzeug £m	MBDA £m
Revenue (100%)	**2,558**	**3,246**	3,110	2,799
Underlying EBITA[1] excluding depreciation	**28**	**454**	12	398
Non-recurring items	**–**	**–**	–	(11)
Depreciation and amortisation	**–**	**(101)**	(1)	(95)
Financial income	**1**	**64**	–	60
Financial expense	**–**	**(72)**	–	(63)
Taxation expense	**(4)**	**(110)**	(2)	(86)
Profit for the year (100%)	**25**	**235**	9	203
Remeasurements on post-employment benefit schemes, net of tax	**–**	**(103)**	–	15
Amounts credited/(charged) to hedging reserve, net of tax	**–**	**36**	–	(11)
Foreign exchange adjustments	**–**	**8**	–	9
Total comprehensive income for the year (100%)	**25**	**176**	9	216
Group's share of total comprehensive income for the year	**8**	**66**	3	81
Non-current assets	**14**	**2,297**	14	2,190
Cash and cash equivalents	**24**	**2,343**	32	2,324
Current assets excluding cash and cash equivalents	**823**	**4,102**	1,006	4,537
Current assets	**847**	**6,445**	1,038	6,861
Non-current financial liabilities excluding trade and other payables, and provisions	**–**	**(5)**	–	(8)
Other non-current liabilities	**(65)**	**(805)**	(33)	(719)
Non-current liabilities	**(65)**	**(810)**	(33)	(727)
Current financial liabilities excluding trade and other payables, and provisions	**–**	**(20)**	–	–
Other current liabilities	**(753)**	**(7,446)**	(988)	(7,808)
Current liabilities	**(753)**	**(7,466)**	(988)	(7,808)
Net assets (100%)	**43**	**466**	31	516

1. Operating profit excluding amortisation and impairment of intangible assets (EBITA), and non-recurring items.

12. Equity accounted investments continued

	2019			2018		
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Group's share of net assets	**14**	**175**	**189**	10	193	203
Goodwill adjustment	**–**	**5**	**5**	–	6	6
Carrying value	**14**	**180**	**194**	10	199	209

	2019			2018		
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Dividends received	**3**	**73**	**76**	2	24	26

Group summary

The Group also has a number of individually immaterial joint ventures and associates, the carrying values of the most significant of which at 31 December 2019 are as follows: Rheinmetall BAE Systems Land (RBSL) (£76m), FADEC International (£45m), FNSS (£42m), Air Astana (£38m), and Panavia Aircraft (£17m). 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 2018	148	174	322
Group's share of profit for the year	79	61	140
Group's share of remeasurements on post-employment benefit schemes	8	–	8
Tax on items that will not be reclassified to the income statement	(2)	–	(2)
Foreign exchange adjustments	3	–	3
Amounts (charged)/credited to hedging reserve	(4)	4	–
Tax on items that may be reclassified to the income statement	–	(1)	(1)
Group's share of total comprehensive income for the year	84	64	148
Purchase of equity accounted investments	–	2	2
Equity accounted investment funding	–	1	1
Dividends received from equity accounted investments	(26)	(31)	(57)
Foreign exchange adjustments	3	10	13
At 31 December 2018	209	220	429
Transition adjustment upon adoption of IFRS 16 Leases (note 36)	(2)	(9)	(11)
At 1 January 2019	207	211	418
Group's share of profit for the year	96	72	168
Group's share of remeasurements on post-employment benefit schemes	(52)	–	(52)
Tax on items that will not be reclassified to the income statement	14	–	14
Foreign exchange adjustments	3	–	3
Amounts credited to hedging reserve	16	15	31
Tax on items that may be reclassified to the income statement	(3)	(3)	(6)
Group's share of total comprehensive income for the year	74	84	158
Equity accounted investment reclassified as held for sale (note 19)	–	(66)	(66)
Fair value of 45% investment retained in RBSL (note 19)	–	76	76
Equity accounted investment funding	–	6	6
Dividends received from equity accounted investments	(76)	(66)	(142)
Foreign exchange adjustments	(11)	(11)	(22)
At 31 December 2019	**194**	**234**	**428**

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

13. Trade, other and contract receivables

Trade receivables are measured at amortised cost under IFRS 9 Financial Instruments as they are held within a business model to collect contractual cash flows and these cash flows consist solely of payments of principal and interest on the principal amount outstanding.

Contract receivables represent amounts for which the Group has an unconditional right to consideration in respect of unbilled revenue recognised at the balance sheet date and comprise costs incurred plus attributable margin.

Trade receivables, contract receivables, amounts owed by equity accounted investments and finance lease receivables include a provision for expected credit losses. The Group measures the provision at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Group writes off a receivable when there is objective evidence that the debtor is in significant financial difficulty and there is no realistic prospect of recovery, for example, when a debtor enters bankruptcy or financial reorganisation.

US deferred compensation plan assets are measured at fair value in accordance with IAS 19 Employee Benefits.

	2019 £m	2018 £m
Non-current		
Contract receivables	**38**	–
Prepayments and accrued income	**62**	25
US deferred compensation plan assets	**322**	306
Finance lease receivables (note 10)	**53**	–
Other receivables	**9**	21
	484	352
Current		
Contract receivables	**2,649**	2,331
Trade receivables	**1,405**	1,427
Amounts owed by equity accounted investments (note 31)	**53**	67
Prepayments and accrued income	**937**	1,025
Finance lease receivables (note 10)	**10**	–
Other receivables[1]	**404**	327
	5,458	5,177

1. Includes £129m (2018 £46m) in relation to VAT receivable in Saudi Arabia.

Contract receivables as at 1 January 2018 were £1,484m.

Trade receivables are stated net of a provision for expected credit losses. Disclosures relating to the ageing of trade receivables and movements in the provision for expected credit losses are provided in note 14.

14. Other financial assets and liabilities and financial risk management

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.

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.

The Group has applied the IFRS 9 general hedge accounting requirements from the date of initial application on 1 January 2018.

Fair value through profit or loss

Gains and losses on derivative financial instruments that are not designated as cash flow hedges are recognised within finance costs in the income statement for the period.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of the exposure to variability in cash flows relating to a highly probable forecast transaction (income or expense) or recognised asset or liability, 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 removed from the hedging reserve and included in the cost of the underlying transaction or reclassified to the income statement when the underlying transaction affects profit or loss. These amounts are presented within the same line item in the income statement as the underlying transaction, typically revenue or operating costs. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement within finance costs immediately. The Group treats the foreign currency basis element of the designated foreign exchange derivative hedging instruments as a cost of hedging and as such it is excluded from the hedge designation.

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 within finance costs in the income statement for the period.

	2019		2018	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**233**	**(221)**	125	(95)
Other foreign exchange/interest rate contracts	**14**	**–**	33	(9)
Debt-related derivative financial instruments	**103**	**(6)**	87	–
	350	**(227)**	245	(104)
Current				
Cash flow hedges – foreign exchange contracts	**203**	**(174)**	79	(63)
Other foreign exchange/interest rate contracts	**7**	**(28)**	9	(9)
Debt-related derivative financial instruments	**–**	**(30)**	78	(2)
	210	**(232)**	166	(74)

Debt-related derivative financial instruments

The debt-related derivative financial instruments represent the fair value of cross-currency, interest rate and foreign exchange derivatives relating to the US$500m 2.85% bond, repayable 2020, the US$500m 4.75% bond, repayable 2021, the US$800m 3.8% bond, repayable 2024, the US$500m 7.5% bond, repayable 2027 and the US$400m 5.8% bond, repayable 2041 (see note 21). These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

None of these debt-related derivative financial instruments are in designated hedge relationships as at 31 December 2019. Interest rate swaps with a fair value of £2m were in a designated fair value hedge relationship at 31 December 2018.

14. Other financial assets and liabilities and financial risk management continued

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% (2018 50%) and a maximum of 90% (2018 90%) of gross debt is maintained at fixed interest rates. At 31 December 2019, the Group had 80% (2018 81%) of fixed rate debt and 20% (2018 19%) of floating rate debt based on a gross debt of £3.3bn (2018 £4.1bn), including debt-related derivative financial assets.

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	2,587	–	–
Loans and overdrafts	675	675	675

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 2019, the Group had a total of $0.9bn ($1.0bn) of this type of swap outstanding with a weighted average duration of 4.8 years (2018 5.8 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 7.1 years (2018 8.5 years). Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 5.3% (2018 5.5%) on US dollars. The cost of the fixed rate debt was 4.7% (2018 4.8%).

Sensitivity analysis

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 approximately £7m (2018 £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 approximately £15m (2018 £20m).

Liquidity risk

Contractual cash outflows on financial liabilities

The contracted cash outflows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash outflows are shown on a gross basis, are not discounted, are translated at the spot rate and include estimated interest payments where applicable. Contracted cash outflows reflects the gross cash outflow on derivative financial instruments and excludes the broadly offsetting cash inflows for the receive leg of derivatives that are settled separately to the pay leg.

	31 December 2019					31 December 2018				
		Contracted cash outflow					Contracted cash outflow			
	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	**(3,397)**	**(533)**	**(1,874)**	**(2,460)**	**(4,867)**	(4,299)	(971)	(1,742)	(3,301)	(6,014)
Cash flow hedges – financial assets	**436**	**(5,098)**	**(5,006)**	**(438)**	**(10,542)**	204	(3,754)	(2,722)	(376)	(6,852)
Cash flow hedges – financial liabilities	**(395)**	**(5,078)**	**(5,933)**	**(602)**	**(11,613)**	(158)	(3,897)	(3,253)	(345)	(7,495)
Other foreign exchange/interest rate contracts – financial assets	**21**	**(351)**	**–**	**–**	**(351)**	42	(756)	–	–	(756)
Other foreign exchange/interest rate contracts – financial liabilities	**(28)**	**(1,679)**	**–**	**–**	**(1,679)**	(18)	(816)	(154)	(36)	(1,006)
Debt-related derivatives – financial assets	**103**	**(53)**	**(213)**	**(370)**	**(636)**	165	(1,109)	(93)	(393)	(1,595)
Debt-related derivatives – financial liabilities	**(36)**	**(442)**	**(248)**	**–**	**(690)**	(2)	(14)	–	–	(14)
Other financial assets and liabilities	**101**					233				

A maturity analysis of the contracted cash outflows on lease liabilities is provided in note 10.

Contractual cash outflows in respect of all other financial liabilities are materially equivalent to the balance sheet carrying amount. Contractual amounts relating to other non-derivative financial liabilities, such as trade payables, are settled within the normal operating cycle of the business (within one year for current liabilities and within two years for the majority of non-current liabilities).

14. Other financial assets and liabilities and financial risk management continued

Borrowing facilities

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2019, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2018 £2bn). The RCF was undrawn throughout the year. The RCF also acts as a backstop to Commercial Paper issued by the Group. At 31 December 2019, the Group had no Commercial Paper in issue (2018 £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 investment-grade credit ratings for short periods. The cash and cash equivalents balance at 31 December 2019 of £2,587m (2018 £3,232m) was invested with 28 (2018 31) 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 using foreign exchange forward contracts and the Group aims, where possible, to apply cash flow hedge accounting to these transactions.

The currency and notional amount of the designated hedging instruments match the currency and principal amounts of the forecast transactions being hedged, therefore the hedging instruments and hedged items have values which will generally move in opposite directions because of the same hedged risk. As the critical terms of the hedging instruments match those of the hedged items, an economic relationship can be demonstrated on an ongoing basis.

The hedge ratio is 1:1 on the basis that the notional amount of the designated hedging instruments matches the principal amount of the forecast foreign currency sales/purchases designated as the hedged items.

The Group considers the potential sources of hedge ineffectiveness to be:

– valuation adjustments for credit risk made to derivative hedging instruments at each hedge effectiveness measurement date;

– changes to the timing and amount of forecast transactions; and

– non-occurrence of the designated hedged items.

The effect of cash flow hedges on the Group's financial position and performance for the year is as follows:

	31 December 2019					31 December 2018				
	Maturity date	**Weighted average hedged rate**	**Change in the value of hedging instruments since 1 January £m**	**Change in the value of hedged items since 1 January £m**	**Notional amount £m**	Maturity date	Weighted average hedged rate	Change in the value of hedging instruments since 1 January £m	Change in the value of hedged items since 1 January £m	Notional amount £m
Purchase/(sale) contracts:										
Sterling/US dollar	**to 2029**	**1.32**	**71**	**(71)**	**(83)**	to 2028	1.37	25	(25)	(872)
Sterling/euro	**to 2029**	**1.11**	**(34)**	**34**	**(640)**	to 2029	1.17	6	(6)	(475)
Other	**to 2026**	**n/a**	**(26)**	**26**	**(46)**	to 2026	n/a	(17)	17	(35)
Cash flow hedges			**11**	**(11)**	**(769)**			14	(14)	(1,382)

The notional amount is the sterling equivalent of the net currency amount purchased or sold. For designated sterling/US dollar cash flow hedges, the Group has purchased $4,527m at a cost of £3,372m and sold $4,267m for £3,289m, resulting in a net purchase of $260m at a cost of £83m. For designated sterling/euro cash flow hedges, the Group has purchased €8,159m at a cost of £7,335m and sold €7,441m for £6,695m, resulting in a net purchase of €718m at a cost of £640m.

14. Other financial assets and liabilities and financial risk management continued

Sensitivity analysis

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 sterling to US dollar exchange rate on the retranslation of US dollar-denominated bonds held by BAE Systems plc is approximately £52m (2018 £56m).

Credit risk

For trade receivables, contract receivables, amounts due from equity accounted investments and finance lease receivables, the Group measures a provision for expected credit losses at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Group's assessment is that credit risk in relation to defence-related sales to government customers or sub-contractors to governments is extremely low as the probability of default is insignificant; therefore the provision for expected credit losses is immaterial in respect of receivables from these customers. For all non-government commercial customers, the Group assesses expected credit losses, however this is not considered material to the financial statements. The Group considers that default has occurred when a receivable is past 180 days overdue, because historical experience indicates that these receivables are generally not recoverable. The Group recognises a provision of 100% against all receivables over 180 days past due unless there is objective evidence that individual receivables in this category are recoverable.

Excluding the UK, US, Saudi Arabian and Qatari governments where credit risk is not considered an issue, no one counterparty constitutes more than 4% of the trade receivables balance (2018 7%).

The carrying amount of the Group's financial assets represents the maximum exposure to credit risk.

Movements on the provision for expected credit losses are as follows:

	2019 £m	2018 £m
At 1 January	**30**	35
Net remeasurement of loss allowance	**(9)**	(3)
Amounts written off	**(1)**	(2)
At 31 December	**20**	30

For contract receivables, amounts due from equity accounted investments and finance lease receivables the expected credit loss provision is immaterial as the probability of default is insignificant.

The Group writes off a receivable when there is objective evidence that the debtor is in significant financial difficulty and there is no realistic prospect of recovery, for example, when a debtor enters bankruptcy or financial reorganisation. None of the trade receivables that were written off during the year are still subject to enforcement activity. The ageing of trade receivables is detailed below:

	2019			2018		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due	**750**	**–**	**750**	873	–	873
Up to 180 days overdue	**388**	**–**	**388**	304	–	304
Past 180 days overdue	**287**	**(20)**	**267**	280	(30)	250
	1,425	**(20)**	**1,405**	1,457	(30)	1,427

Trade receivables past 180 days overdue primarily relate to contracts in Saudi Arabia. The Group has assessed the risk of default and recoverability of these receivables at the balance sheet date and the expected credit losses in respect of these balances are not considered to be material.

Offsetting financial assets and liabilities

		2019					2018				
	Notes	Gross balances[1] £m	Amounts offset[2] £m	Balance sheet[3] £m	Amounts not offset[4] £m	Net balances[5] £m	Gross balances[1] £m	Amounts offset[2] £m	Balance sheet[3] £m	Amounts not offset[4] £m	Net balances[5] £m
Assets											
Cash and cash equivalents	18	**2,593**	**(6)**	**2,587**	**–**	**2,587**	3,244	(12)	3,232	–	3,232
Other financial assets		**560**	**–**	**560**	**(432)**	**128**	411	–	411	(172)	239
Liabilities											
Overdrafts	21	**(6)**	**6**	**–**	**–**	**–**	(12)	12	–	–	–
Other financial liabilities		**(459)**	**–**	**(459)**	**412**	**(47)**	(178)	–	(178)	153	(25)

1. The gross amounts of the recognised financial assets and liabilities.
2. The amounts offset in accordance with paragraph 42 of IAS 32.
3. The net balances presented in the Consolidated balance sheet.
4. The amounts subject to a master netting arrangement not offset in the Consolidated balance sheet in accordance with paragraph 42 of IAS 32. Includes £412m (2018 £153m) in respect of recognised financial instruments and £20m (2018 £19m) in respect of cash collateral.
5. The net balances after deducting the amounts in (4) from (3).

15. 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/post-employment schemes (see below). This is because post-employment 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/post-employment schemes or when post-employment 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 under which the deficits are expected to be cleared in 2026 (see note 23).

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	
	2019 £m	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m
Property, plant and equipment	**36**	28	**(85)**	(85)	**(49)**	(57)
Intangible assets	**–**	2	**(1)**	(3)	**(1)**	(1)
Provisions and accruals	**194**	202	**–**	–	**194**	202
Goodwill	**–**	–	**(278)**	(283)	**(278)**	(283)
Pension/post-employment schemes:						
Deficits	**759**	722	**–**	–	**759**	722
Additional contributions and other[1]	**98**	97	**(1)**	(1)	**97**	96
Share-based payments	**20**	12	**–**	–	**20**	12
Financial instruments	**–**	–	**(7)**	(12)	**(7)**	(12)
Other items	**10**	14	**(27)**	(8)	**(17)**	6
Rolled over capital gains	**–**	–	**(10)**	(10)	**(10)**	(10)
Capital losses carried forward	**10**	10	**–**	–	**10**	10
Trading losses carried forward	**8**	17	**–**	–	**8**	17
Deferred tax assets/(liabilities)	**1,135**	1,104	**(409)**	(402)	**726**	702
Set off of tax	**(409)**	(402)	**409**	402	**–**	–
Net deferred tax assets	**726**	702	**–**	–	**726**	702

1. Includes deferred tax assets on US deferred compensation plans.

15. Deferred tax continued

Movement in temporary differences during the year

	At 1 January 2019 £m	Foreign exchange adjustments £m	Acquisitions and disposals[1] £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2019 £m**
Property, plant and equipment	(57)	3	–	5	–	**(49)**
Intangible assets	(1)	1	(1)	–	–	**(1)**
Provisions and accruals	202	(8)	–	–	–	**194**
Goodwill	(283)	10	–	(5)	–	**(278)**
Pension/post-employment schemes:						
Deficits	722	(4)	–	12	29	**759**
Additional contributions and other[2]	96	(3)	–	4	–	**97**
Share-based payments	12	1	–	6	1	**20**
Financial instruments	(12)	1	–	4	–	**(7)**
Other items[3]	8	1	–	(26)	–	**(17)**
Rolled over capital gains	(10)	–	–	–	–	**(10)**
Capital losses carried forward	10	–	–	–	–	**10**
Trading losses carried forward	17	(2)	(4)	(3)	–	**8**
	704	–	(5)	(3)	30	**726**

	At 1 January 2018 £m	Foreign exchange adjustments £m	Acquisitions and disposals[1] £m	Recognised in income £m	Recognised in equity £m	At 31 December 2018 £m
Property, plant and equipment	(78)	(5)	–	26	–	(57)
Intangible assets	(1)	–	–	–	–	(1)
Provisions and accruals	205	9	–	(12)	–	202
Goodwill	(275)	(16)	–	8	–	(283)
Pension/post-employment schemes:						
Deficits	728	9	–	4	(19)	722
Additional contributions and other[2]	99	6	–	(9)	–	96
Share-based payments	14	–	–	(1)	(1)	12
Financial instruments	(11)	–	–	(6)	5	(12)
Other items	5	(1)	–	2	–	6
Rolled over capital gains	(10)	–	–	–	–	(10)
Capital losses carried forward	10	–	–	–	–	10
Trading losses carried forward	12	1	–	4	–	17
	698	3	–	16	(15)	702

1. Comprises the transfer of net deferred tax assets to held for sale.
2. Includes deferred tax assets on US deferred compensation plans.
3. Balance at 1 January 2019 includes £2m recognised on adoption of IFRS 16 Leases (see note 36).

Unrecognised deferred tax assets and liabilities

Deferred tax assets have not been recognised in respect of the following items:

	2019		2018	
	Gross amount £m	**Unrecognised deferred tax asset £m**	Gross amount £m	Unrecognised deferred tax asset £m
Deductible temporary differences, including tax credits	**3**	**2**	2	2
Capital losses carried forward	**221**	**38**	233	41
Trading and other losses carried forward	**202**	**24**	217	26
	426	**64**	452	69

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 £191m (2018 £354m) 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.

15. Deferred tax continued

Changes in tax rates

Recognised US deferred tax balances have been calculated at a combined federal and state tax rate of 25.7% (2018 25.7%).

Legislation is in place for the UK current tax rate to be reduced from 19% to 17% with effect from 1 April 2020. Both recognised and unrecognised UK deferred tax balances as at 31 December 2019 have therefore been calculated at a rate of 17% (2018 17.5%). However, the Conservative Party's 2019 election manifesto included a pledge to keep the rate unchanged and so there is an expectation that the Budget in March will bring forward legislation to retain the UK current tax rate at 19%. The estimated impact of increasing the rate at which recognised UK deferred tax balances are calculated from 17% to 19% is an increase in net assets of £78m, the majority of which will be recorded in the Consolidated statement of comprehensive income.

16. Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

	2019 £m	2018 £m
Raw materials and consumables	**375**	354
Work-in-progress	**348**	319
Finished goods and goods for resale	**112**	101
	835	774

The Group recognised £14m (2018 £11m) as a write down of inventories to net realisable value.

17. Current tax

Current tax for the current and prior periods is recognised as a liability to the extent that it has not yet been settled, and as an asset to the extent that the amounts already paid exceed the amount due or the benefit of a tax loss can be carried back to recover current tax of a prior period. Current tax assets and liabilities are measured at the amount expected to be paid to or recovered from taxation authorities, using the rates that have been enacted or substantively enacted by the balance sheet date.

	2019 £m	2018 £m
Tax provisions	**(180)**	(361)
Research and development expenditure credits receivable	**187**	163
Other	**(43)**	(55)
	(36)	(253)
Represented by:		
Current tax assets	**19**	81
Current tax liabilities	**(55)**	(334)
	(36)	(253)

Tax provisions of £180m (2018 £361m) are in respect of known tax issues, of which £142m (2018 £44m) relates to the UK. Whilst there is inherent uncertainty regarding the timing of any resolution of tax positions, the Group considers there to be a possibility of a material change in UK tax positions in the next financial year.

Following review of the April 2019 EU Commission decision that concluded that the UK's Controlled Foreign Company regime partially represents State Aid, a provision has been recognised in the UK for the estimated exposure. There remains uncertainty surrounding HMRC's likely approach to the assessment of the deemed State Aid and recovery of amounts which they consider to be due, and, accordingly, developments will continue to be monitored and assessed.

18. 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.

	2019 £m	2018 £m
Cash	**1,039**	735
Money market funds	**680**	908
Short-term deposits	**868**	1,589
	2,587	3,232

Cash and cash equivalents includes £283m (2018 £278m) which is subject to regulatory restrictions and is therefore not available for general use by other entities within the Group.

19. Assets and liabilities held for sale and business disposals

Assets and liabilities of disposal groups classified as held for sale comprise assets and liabilities that are expected to be recovered primarily through sale rather than continuing use. Assets and liabilities of disposal groups classified as held for sale are measured at the lower of their carrying value and fair value less costs to sell.

AACC

In January 2019, as part of a planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia, the Group's Overhaul and Maintenance Company (OMC) subsidiary disposed of its 85.7% shareholding in Aircraft Accessories and Components Company (AACC) to Saudi Arabian Military Industries (SAMI). AACC was presented as held for sale at 31 December 2018.

AACC was included in the Air segment.

UK-based combat vehicles

In January 2019, the Group announced an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Rheinmetall purchased a 55% stake in the existing BAE Systems UK-based combat vehicles business, with BAE Systems retaining 45%. The UK-based combat vehicles business was presented as held for sale at 31 December 2018.

The sale of the stake to Rheinmetall and creation of Rheinmetall BAE Systems Land (RBSL), completed on 1 July 2019. The Group's stake in RBSL is accounted for as an equity accounted investment from 1 July 2019.

The UK-based combat vehicles business and RBSL are included in the Maritime segment.

AEC

In 2019, the Group's OMC subsidiary entered into a heads of terms for the sale of its 50% shareholding in Advanced Electronics Company (AEC) to SAMI. Negotiations are continuing and the sale is expected to complete in 2020. Accordingly, AEC is presented as held for sale at 31 December 2019.

AEC is included in the Air segment.

Silversky

Divestment of the Silversky business is in progress. Accordingly, the business is presented as held for sale at 31 December 2019.

Silversky is included in the Cyber & Intelligence segment.

Business disposals

The profit recognised on the disposal of each business was as follows:

	2019		
	UK-based combat vehicles £m	AACC £m	Total £m
Fair value of consideration received	31	26	57
Net assets disposed	(93)	(26)	(119)
Fair value of 45% investment retained in RBSL (note 12)	76	–	76
Cumulative currency translation gain	–	8	8
Profit on disposal	**14**	**8**	**22**
Net cash inflow arising on disposal:			
Cash consideration received	31	26	57
Less: cash and cash equivalents disposed	(2)	–	(2)
	29	**26**	**55**

The profit on disposal is included in the profit for the year from continuing operations, as a component of other income (note 4).

19. Assets and liabilities held for sale and business disposals continued

The net assets of the respective disposal groups at the dates of their disposal were as follows:

	2019		
	UK-based combat vehicles £m	AACC £m	Total £m
Intangible assets	87	–	87
Property, plant and equipment	9	8	17
Inventories	2	17	19
Trade, other and contract receivables	15	9	24
Cash and cash equivalents	2	–	2
Trade and other payables	(15)	(8)	(23)
Provisions	(7)	–	(7)
Net assets disposed	**93**	**26**	**119**

There were no disposals of subsidiaries in 2018.

Assets and liabilities held for sale

Assets and liabilities presented as held for sale comprise:

	2019			2018		
	Silversky £m	**AEC £m**	**Total £m**	UK-based combat vehicles £m	AACC £m	Total £m
Intangible assets	**31**	**17**	**48**	87	–	87
Property, plant and equipment	**3**	**8**	**11**	9	6	15
Equity accounted investments	**–**	**66**	**66**	–	–	–
Deferred tax assets	**5**	**–**	**5**	–	–	–
Inventories	**–**	**–**	**–**	2	17	19
Trade, other and contract receivables	**5**	**–**	**5**	16	9	25
Assets held for sale	**44**	**91**	**135**	114	32	146
Trade and other payables	**(5)**	**–**	**(5)**	(19)	(14)	(33)
Provisions	**–**	**–**	**–**	(7)	–	(7)
Liabilities held for sale	**(5)**	**–**	**(5)**	(26)	(14)	(40)

20. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	**2019 £m**	2018 £m
UK		**4,119**	3,610
Rest of Europe		**935**	909
US		**8,830**	8,466
Saudi Arabia		**679**	503
Australia		**435**	420
Rest of Asia and Pacific		**10**	7
Non-current segment assets		**15,008**	13,915
Post-employment benefit surpluses	23	**302**	308
Other financial assets	14	**560**	411
Tax	15,17	**745**	783
Inventories	16	**835**	774
Current trade, other and contract receivables	13	**5,458**	5,177
Cash and cash equivalents	18	**2,587**	3,232
Assets held for sale	19	**135**	146
Consolidated total assets		**25,630**	24,746

21. Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost. Any difference between the amount initially recognised and the redemption value is recognised in the income statement over the period of the borrowings.

	2019 £m	2018 £m
Non-current		
US$500m 2.85% bond, repayable 2020	**–**	391
US$500m 4.75% bond, repayable 2021	**377**	392
£400m 4.125% bond, repayable 2022	**399**	399
US$800m 3.8% bond, repayable 2024	**602**	626
US$750m 3.85% bond, repayable 2025	**561**	583
US$500m 7.5% bond, repayable 2027	**376**	391
US$400m 5.8% bond, repayable 2041	**299**	311
US$550m 4.75% bond, repayable 2044	**406**	421
	3,020	3,514
Current		
US$1bn 6.375% bond, repayable 2019	**–**	785
US$500m 2.85% bond, repayable 2020	**377**	–
	377	785

The US$1bn 6.375% bond, of which US$500m had been converted to a floating rate bond by utilising interest rate swaps, matured and was repaid in June 2019.

The US$500m 2.85% bond, repayable 2020, has been converted to a sterling fixed rate bond by utilising foreign exchange swaps that mature in February 2020 and give an effective rate during 2019 of 1.2%.

US$278m of the US$500m 4.75% bond, repayable 2021, has been converted to a sterling fixed rate bond by utilising foreign exchange swaps that mature in October 2021 and give an effective rate during 2019 of 4.7%.

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 2024 and give an effective rate during 2019 of 3.8%.

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 rate during 2019 of 7.7%.

The US$400m 5.8% bond, repayable 2041, has been converted to a floating rate bond by utilising interest rate swaps that mature in October 2024 and give an effective rate during 2019 of 5.7%.

22. Trade and other payables

Trade and other payables are stated at amortised cost.

Contract liabilities represent the obligation to transfer goods or services to a customer for which consideration has been received, or consideration is due, from the customer.

US deferred compensation plan liabilities represent the present value of expected future payments required to settle the obligation to employees in accordance with IAS 19 Employee Benefits.

	2019 £m	2018[1] £m
Non-current		
Contract liabilities	**527**	560
Accruals and deferred income[2]	**584**	520
US deferred compensation plan liabilities	**339**	333
Other payables	**31**	48
	1,481	1,461
Current		
Contract liabilities	**3,536**	3,496
Trade payables	**675**	703
Amounts owed to equity accounted investments (note 31)	**1,134**	955
Other taxes and social security costs	**123**	130
Accruals and deferred income	**2,229**	2,201
Other payables	**229**	233
	7,926	7,718

1. Comparatives as at 31 December 2018 have been reclassified to present the Saudi Arabia end of service benefit obligation within post-employment benefit obligations (£97m previously presented within other payables, see note 23) and to present accruals for goods received not invoiced within accruals and deferred income (£208m previously presented within trade payables).
2. Includes £525m (2018 £439m) of funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme.

Revenue recognised in the year includes £3,422m (2018 £2,571m) that was included in the opening contract liabilities balance.

Non-current and current contract liabilities as at 1 January 2018 were £802m and £2,717m, respectively.

23. Post-employment 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 post-employment 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 204. 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 2019.

MBDA participates 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 MBDA based on the relative payroll contributions of active members or actual obligations where known. 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.

The Group's share of the IAS 19 pension deficit allocated to equity accounted investments is included in the balance sheet within equity accounted investments.

Background

Pension schemes

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. During 2019, several legacy BAE Systems pension arrangements were merged into the BAE Systems Pension Scheme (Main Scheme). Contributions and members' benefits are unchanged. The largest funded defined benefit scheme is the Main Scheme which represents 93% (2018 93%) of the UK IAS 19 defined benefit obligation at 31 December 2019. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2019, the weighted average durations of the UK and US defined benefit pension obligations were 17 years (2018 17 years) and 11 years (2018 11 years), respectively.

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme and US schemes in aggregate is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme (merged)[1]	31	21	48
US schemes[2]	28	16	56

1. Source: 31 October 2019 actuarial valuation reports for the legacy schemes within the recently-merged Main Scheme.
2. Source: Annual updates of the US schemes as at 1 January 2019.

23. Post-employment benefits continued

Background 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 Guaranty 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 the majority of active members of the Main Scheme 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.

A UK High Court judgement was delivered on 26 October 2018 concerning gender equalisation for the effect of Guaranteed Minimum Pensions (GMPs) for occupational pension schemes. In 2018, a non-recurring past service cost was included in the income statement to reflect the expectation that the impact of GMP equalisation would increase the pension deficit in the balance sheet. In 2019, an allowance of £132m (2018 £121m) was included within the pension deficit (before allocation to equity accounted investments). This is a consistent proportion of the UK liabilities as applied in 2018 and reflects the updated UK IAS 19 valuations as at 31 December 2019.

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.

Other post-employment benefits

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 Group provides an end of service benefit to employees in Saudi Arabia. These liabilities are presented within post-employment benefits as at 31 December 2019; however, as at 31 December 2018, these liabilities were presented within other payables. The balance sheet has been reclassified to include this balance within post-employment benefits as the Group considers this to be a more appropriate presentation. This balance is not considered material, however the comparative balance sheet has been reclassified for consistency. This reclassification has had no impact on the net assets, the income statement or the statement of comprehensive income. A third balance sheet as at 1 January 2018 is not presented as the reclassification does not have a material effect at that date.

Funding

Introduction

Disclosures in respect of pension funding are provided below. Disclosures in respect of pension accounting under IAS 19 are provided on pages 204 to 210.

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 at the valuation date, whilst the liabilities are measured on an actuarial funding basis using the projected unit credit method and discounted to their present value based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The funding valuations are performed by professionally qualified independent actuaries and include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 204. The purpose of the funding valuations is to design funding plans which ensure that the schemes have sufficient funds available to meet future benefit payments.

23. Post-employment benefits continued

Funding continued

UK valuations

Funding valuations of the Group's UK defined benefit pension schemes are performed every three years. Following the merger of several of the Group's UK pension schemes in October 2019, the Company and trustees agreed to carry out an early triennial funding valuation for the Main Scheme as at 31 October 2019. The next funding valuations for the other UK schemes will have an effective date of no later than 31 March 2020.

The results of the most recent triennial valuations are shown below. These valuations and, where necessary, deficit recovery plans were agreed with the trustees and certified by the scheme actuaries after consultation with The Pensions Regulator in the UK.

	Main Scheme as at 31 October 2019 £bn	Other schemes as at 31 March 2017 £bn
Market value of assets	20.6	2.2
Present value of liabilities	(22.5)	(2.0)
Funding (deficit)/surplus	(1.9)	0.2
Percentage of accrued benefits covered by the assets at the valuation date	92%	110%

The valuations in 2017 and 2019 were determined using the following mortality assumptions:

Life expectancy of a male currently aged 65 (years)	86 – 89
Life expectancy of a female currently aged 65 (years)	87 – 90
Life expectancy of a male currently aged 45 (years)	88 – 92
Life expectancy of a female currently aged 45 (years)	90 – 93

The discount rate assumptions used in the 2017 and 2019 valuations were directly based on prudent levels of expected returns for the assets held by the schemes, reflecting the planned investment strategies and maturity profiles of each scheme. The discount rates are curves which provide a different rate for each year into the future.

The inflation assumptions were derived using data from the Bank of England which is based on the difference between the yields on index-linked and fixed interest long-term government bonds. The inflation assumption is a curve which provides a different rate for each year into the future.

The funding valuations resulted in a significantly lower deficit than under IAS 19, largely due to lower liabilities reflecting the higher discount rate assumption. Under IAS 19, the discount rate for accounting purposes is based on third-party AA corporate bond yields whereas, for funding valuation purposes, the discount rate is based on a prudent level of expected returns from the broader and mixed types of investments reflected in the schemes' investment strategies, which are expected overall to yield higher returns than bonds.

The 2019 funding agreement is underpinned by a contingency plan, which includes a commitment by the Group to a further £50m of deficit funding in each of 2021 and 2022 into the Main Scheme prior to the next triennial valuation in the event that the scheme funding level were to fall below pre-determined parameters. In addition, the Group would be required to pay £187m in respect of the Main Scheme if the funding level were to fall significantly and were to remain at or below those levels for nine months.

There have been no changes to the contributions or benefits, as set out in the rules of the schemes, for pension scheme members as a result of the new funding valuations.

The results of future triennial valuations and associated funding requirements will be impacted by a number of factors, including the future performance of investment markets and anticipated members' longevity.

US valuations

The Group's US pension schemes are valued annually, with the latest valuations performed as at 1 January 2019.

23. Post-employment benefits continued

Funding continued

Contributions

Under the terms of the trust deeds of the UK schemes, the Group is required to have a funding plan determined at the conclusion of the triennial funding valuations.

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 2019, total employer contributions to the Group's pension schemes were £461m (2018 £554m), including amounts funded by equity accounted investments of £40m (2018 £38m), and included approximately £231m (2018 £211m) of deficit recovery payments in respect of the UK schemes, and £nil (2018 £119m) in respect of the US schemes.

Deficit contributions will further increase in line with any percentage growth in dividend payments made by the Group. As part of the 31 October 2019 valuation agreement, the Company has agreed to pay £1bn into the Main Scheme in the coming months representing an advancement of £1bn in deficit contributions that were due, under the 2017 valuation deficit recovery plan, between 2022 and 2026. The annual payments are expected to end in 2021 and the deficit is expected to be cleared in 2026.

In 2020, Group contributions to the US pension schemes are expected to increase by approximately £60m.

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 reduce the exposure of the total portfolio to a materially adverse impact from a single security or type of security. 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 45% (2018 43%) 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. The Main Scheme has an equity option strategy protecting £2.9bn 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, 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 discount rate assumptions set as part of the UK funding valuations directly reflect the expected returns on assets held by the schemes and provide a natural hedge against interest rate risk. The planned investment strategy, which is reflected in the discount rate and liability calculation, is for the schemes to increase their investments in bonds or other assets which match the liabilities as the schemes mature. Under the UK funding valuations, the Group expects the schemes to be fully hedged against interest rate movements following a five-year transition period to the planned investment strategy.
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 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's US schemes are not indexed with inflation. The UK funding valuations provide a natural hedge against inflation movements within the discount rate. The Group is already fully hedged against inflation movements and, under the planned investment strategy, the Group aims to maintain a fully hedged position. In 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 2013, with the agreement of the Company, the trustees of the 2000 Plan, Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme entered into arrangements with Legal & General to insure against longevity risk for the current pensioner population, covering a total of £4.4bn of pension scheme liabilities. These arrangements reduce the funding volatility relating to increasing life expectancy. This longevity risk cover with Legal & General remains in place following the merger of the 2000 Plan and SIPS into the Main Scheme.

23. Post-employment benefits continued

IAS 19 accounting

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.

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		
	2019	2018	2017	**2019**	2018	2017
Financial assumptions						
Discount rate – past service (%)	**2.1**	2.9	2.6	**3.1**	4.2	3.7
Discount rate – future service (%)	**2.2**	3.0	2.7	**3.1**	4.2	3.7
Retail Prices Index (RPI) inflation (%)	**2.8**	3.1	3.1	**n/a**	n/a	n/a
Rate of increase in salaries (%)	**2.8**	3.1	3.1	**n/a**	n/a	n/a
Rate of increase in deferred pensions (%)	**2.0/2.8**	2.1/3.1	2.1/3.1	**n/a**	n/a	n/a
Rate of increase in pensions in payment (%)	**1.5 – 3.6**	1.6 – 3.7	1.6 – 3.7	**n/a**	n/a	n/a
Demographic assumptions						
Life expectancy of a male currently aged 65 (years)	**87 – 88**	86 – 88	86 – 88	**87**	87	87
Life expectancy of a female currently aged 65 (years)	**88 – 90**	88 – 90	88 – 90	**89**	89	89
Life expectancy of a male currently aged 45 (years)	**88 – 89**	88 – 90	88 – 90	**87**	87	87
Life expectancy of a female currently aged 45 (years)	**89 – 91**	90 – 91	90 – 92	**89**	89	89

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments 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. For the UK territory, the discount rate used for future service differs from that used for past service as it only uses the cash flows relating to active members, which have a different duration. Further information on the duration of the schemes is detailed on page 200.

Retail Prices Index (RPI) 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. As a consequence of RPI reform announcements during 2019, the Company has reviewed its approach to setting inflation assumptions and has decided to set the Consumer Prices Index (CPI) assumption at 0.8% lower than RPI. The resulting CPI assumption is 2.0%. In the US, inflation assumptions are not relevant 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 RPI inflation of 2.8% (2018 RPI inflation of 3.1%), 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 CPI inflation of 2.0% (2018 CPI inflation of 2.1%), with the exception of the legacy 2000 Plan, which is based on RPI inflation of 2.8% (2018 RPI inflation of 3.1%). 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' benefits 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 and information on the demographic profile of the scheme's membership. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2018 tables (published by the Institute of Actuaries) have been used (in 2018, the Continuous Mortality Investigation 2017 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.0% (2018 1.25%), an initial rate adjustment parameter ('A') of 0.25% in conjunction with a smoothing parameter ('S_k') of 7 for all members.

In October 2019, 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 2019 are a blend of the fully generational PRI-2012 White Collar table and the PRI-2012 Blue Collar table, both projected using Scale MP-2019.

US healthcare schemes

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 2019. These valuations were rolled forward to reflect the information at 31 December 2019. The method of accounting for these is similar to that used for defined benefit pension schemes.

The assumption for long-term healthcare cost increases is 4.8% (2018 4.9%) based on the assumptions that the increases are 7.4% in 2019 reducing to 4.5% by 2026 and 4.5% each year thereafter for pre-retirement, and 8% in 2019 reducing to 4.5% by 2026 and 4.5% each year thereafter for post-retirement.

23. Post-employment benefits continued

IAS 19 accounting continued

Summary of movements in post-employment benefit obligations

	UK £m	US and other £m	Total £m
Total net IAS 19 deficit at 1 January 2019[1]	(3,554)	(779)	(4,333)
Actual return on assets excluding amounts included in net interest expense	1,491	766	2,257
Increase in liabilities due to changes in financial assumptions	(2,547)	(638)	(3,185)
Decrease in liabilities due to changes in demographic assumptions	448	19	467
Experience losses	(96)	(28)	(124)
Contributions in excess of/(below) service cost	243	(22)	221
Past service cost – plan amendments	(4)	–	(4)
Net interest expense	(92)	(28)	(120)
Foreign exchange adjustments	–	28	28
Movement in other schemes	–	14	14
Total net IAS 19 deficit at 31 December 2019	**(4,111)**	**(668)**	**(4,779)**
Allocated to equity accounted investments	324	–	324
Group's share of net IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments at 31 December 2019	**(3,787)**	**(668)**	**(4,455)**

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-employment benefit schemes and the amounts recognised on the Group's balance sheet after allocation to equity accounted investments.

	2019				
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Saudi Arabia end of service benefit[1] £m	Total £m
Present value of unfunded obligations	**(118)**	**(143)**	**–**	**(105)**	**(366)**
Present value of funded obligations	**(26,758)**	**(5,174)**	**(168)**	**–**	**(32,100)**
Fair value of scheme assets	**22,765**	**4,703**	**219**	**–**	**27,687**
Total net IAS 19 (deficit)/surplus	**(4,111)**	**(614)**	**51**	**(105)**	**(4,779)**
Allocated to equity accounted investments	**324**	**–**	**–**	**–**	**324**
Group's share of net IAS 19 (deficit)/surplus	**(3,787)**	**(614)**	**51**	**(105)**	**(4,455)**
Represented by:					
Post-employment benefit surpluses	**234**	**11**	**57**	**–**	**302**
Post-employment benefit obligations	**(4,021)**	**(625)**	**(6)**	**(105)**	**(4,757)**
	(3,787)	**(614)**	**51**	**(105)**	**(4,455)**
Group's share of net IAS 19 deficit of equity accounted investments	**(129)**	**–**	**–**	**–**	**(129)**

1. At 31 December 2018 the Saudi Arabia end of service benefit was presented within other payables. The comparative balance sheet has been reclassified to include this balance within post-employment benefits as the Group considers this to be a more appropriate presentation.

23. Post-employment benefits continued

IAS 19 accounting continued

	2018				
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Saudi Arabia end of service benefit[1] £m	Total £m
Present value of unfunded obligations	(100)	(142)	–	(97)	(339)
Present value of funded obligations	(24,700)	(4,782)	(165)	–	(29,647)
Fair value of scheme assets	21,246	4,213	194	–	25,653
Total net IAS 19 (deficit)/surplus	(3,554)	(711)	29	(97)	(4,333)
Allocated to equity accounted investments	304	–	–	–	304
Group's share of net IAS 19 (deficit)/surplus	(3,250)	(711)	29	(97)	(4,029)
Represented by:					
Post-employment benefit surpluses	219	48	41	–	308
Post-employment benefit obligations	(3,469)	(759)	(12)	(97)	(4,337)
	(3,250)	(711)	29	(97)	(4,029)
Group's share of net IAS 19 deficit of equity accounted investments	(119)	–	–	–	(119)

1. At 31 December 2018 the Saudi Arabia end of service benefit was presented within other payables. The comparative balance sheet has been reclassified to include this balance within post-employment benefits as the Group considers this to be a more appropriate presentation.

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £5.2bn (2018 £4.6bn).

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	Saudi Arabia end of service benefit[1] £m	Total £m
Value of scheme assets at 1 January 2018	22,332	4,352	199	–	26,883
Interest income	575	156	7	–	738
Actual return on assets excluding amounts included in interest income	(1,022)	(422)	(12)	–	(1,456)
Actual return on assets	(447)	(266)	(5)	–	(718)
Contributions by employer	423	131	1	77	632
Contributions by employer in respect of employee salary sacrifice arrangements	80	–	–	–	80
Total contributions by employer	503	131	1	77	712
Members' contributions	7	–	–	–	7
Administrative expenses	(14)	(14)	(1)	–	(29)
Foreign exchange translation	–	248	12	–	260
Benefits paid	(1,135)	(238)	(12)	(77)	(1,462)
Value of scheme assets at 31 December 2018	21,246	4,213	194	–	25,653
Interest income	609	173	8	–	790
Actual return on assets excluding amounts included in interest income	1,491	766	32	–	2,289
Actual return on assets	2,100	939	40	–	3,079
Contributions by employer	451	10	2	37	500
Contributions by employer in respect of employee salary sacrifice arrangements	78	–	–	–	78
Total contributions by employer	529	10	2	37	578
Members' contributions	7	–	–	–	7
Administrative expenses	(15)	(21)	(1)	–	(37)
Foreign exchange translation	–	(185)	(9)	–	(194)
Benefits paid	(1,102)	(253)	(7)	(37)	(1,399)
Value of scheme assets at 31 December 2019	**22,765**	**4,703**	**219**	**–**	**27,687**

1. At 31 December 2018 the Saudi Arabia end of service benefit was presented within other payables. The comparative balance sheet has been reclassified to include this balance within post-employment benefits as the Group considers this to be a more appropriate presentation.

23. Post-employment benefits continued

IAS 19 accounting continued

Assets of defined benefit pension schemes

	2019								
	UK[1]			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK[2]	2,214	1	2,215	–	–	–	2,214	1	2,215
Overseas	1,935	1	1,936	–	–	–	1,935	1	1,936
Pooled investment vehicles[3]	1,931	5,161	7,092	1,178	1	1,179	3,109	5,162	8,271
Fixed interest securities:									
UK gilts	1,280	–	1,280	–	–	–	1,280	–	1,280
UK corporates	1,476	2,359	3,835	–	–	–	1,476	2,359	3,835
Overseas government	41	–	41	34	–	34	75	–	75
Overseas corporates	1,480	16	1,496	3,304	–	3,304	4,784	16	4,800
Index-linked securities:									
UK gilts	2,105	297	2,402	–	–	–	2,105	297	2,402
UK corporates	268	994	1,262	–	–	–	268	994	1,262
Property[4]	–	1,778	1,778	–	113	113	–	1,891	1,891
Derivatives[5]	–	(1,405)	(1,405)	–	–	–	–	(1,405)	(1,405)
Cash:									
Sterling	619	29	648	–	–	–	619	29	648
Foreign currency	31	5	36	72	–	72	103	5	108
Other	13	136	149	–	1	1	13	137	150
Total	13,393	9,372	22,765	4,588	115	4,703	17,981	9,487	27,468

	2018								
	UK[1]			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK[2]	3,192	1	3,193	–	–	–	3,192	1	3,193
Overseas	1,882	12	1,894	284	–	284	2,166	12	2,178
Pooled investment vehicles[3]	1,280	3,713	4,993	659	2	661	1,939	3,715	5,654
Fixed interest securities:									
UK gilts	1,500	–	1,500	–	–	–	1,500	–	1,500
UK corporates	1,543	1,949	3,492	–	–	–	1,543	1,949	3,492
Overseas government	47	–	47	19	–	19	66	–	66
Overseas corporates	1,260	43	1,303	3,074	–	3,074	4,334	43	4,377
Index-linked securities:									
UK gilts	2,156	177	2,333	–	–	–	2,156	177	2,333
UK corporates	526	653	1,179	–	–	–	526	653	1,179
Property[4]	–	1,935	1,935	–	125	125	–	2,060	2,060
Derivatives[5]	–	(1,121)	(1,121)	–	–	–	–	(1,121)	(1,121)
Cash:									
Sterling	270	33	303	–	–	–	270	33	303
Foreign currency	10	5	15	49	–	49	59	5	64
Other	46	134	180	–	1	1	46	135	181
Total	13,712	7,534	21,246	4,085	128	4,213	17,797	7,662	25,459

1. The Main Scheme and one of the Group's smaller UK defined benefit pension schemes participate in a Combined Investment Fund (CIF), covering £10.1bn (2018 £9.7bn) of assets. The purpose of the CIF is to provide economies of scale for the CIF schemes' investment administration.
2. Includes £15m (2018 £24m) of the Company's own ordinary shares.
3. Primarily invested in private markets and exchange traded funds. The amounts classified as unquoted primarily comprise investments in private markets, with the majority held in infrastructure, alternatives and direct funds, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.
4. 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 £233m (2018 £245m) of property occupied by Group companies.
5. Includes equity protection options, forward foreign exchange contracts, futures, and interest rate, inflation and longevity swaps. In addition, the total derivative figures shown are net of £358m (2018 £479m) of repurchase agreements. The valuations are based on valuation techniques using underlying market data and discounted cash flows.

23. Post-employment benefits continued

IAS 19 accounting 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	Saudi Arabia end of service benefit[1] £m	Total £m
Defined benefit obligations at 1 January 2018	(26,120)	(4,949)	(168)	(148)	(31,385)
Current service cost	(224)	(12)	(1)	(22)	(259)
Contributions by employer in respect of employee salary sacrifice arrangements	(80)	–	–	–	(80)
Total current service cost	(304)	(12)	(1)	(22)	(339)
Members' contributions	(7)	–	–	–	(7)
Past service cost – plan amendments	(131)	–	–	–	(131)
Actuarial gain due to changes in financial assumptions	1,295	265	9	–	1,569
Actuarial gain due to changes in demographic assumptions	171	17	–	–	188
Experience losses	(176)	(17)	(1)	–	(194)
Interest expense	(663)	(180)	(6)	(7)	(856)
Foreign exchange translation	–	(286)	(10)	3	(293)
Benefits paid	1,135	238	12	77	1,462
Defined benefit obligations at 31 December 2018	(24,800)	(4,924)	(165)	(97)	(29,986)
Current service cost	(193)	(11)	(1)	(17)	(222)
Contributions by employer in respect of employee salary sacrifice arrangements	(78)	–	–	–	(78)
Total current service cost	(271)	(11)	(1)	(17)	(300)
Members' contributions	(7)	–	–	–	(7)
Past service cost – plan amendments	(4)	–	–	–	(4)
Actuarial loss due to changes in financial assumptions	(2,547)	(638)	(19)	(26)	(3,230)
Actuarial gain due to changes in demographic assumptions	448	19	1	–	468
Experience (losses)/gains	(96)	(28)	8	(2)	(118)
Interest expense	(701)	(201)	(6)	(5)	(913)
Foreign exchange translation	–	213	7	5	225
Benefits paid	1,102	253	7	37	1,399
Defined benefit obligations at 31 December 2019	**(26,876)**	**(5,317)**	**(168)**	**(105)**	**(32,466)**

1. At 31 December 2018 the Saudi Arabia end of service benefit was presented within other payables. The comparative balance sheet has been reclassified to include this balance within post-employment benefits as the Group considers this to be a more appropriate presentation.

23. Post-employment benefits continued

IAS 19 accounting continued

Amounts recognised in the income statement after allocation to equity accounted investments

	2019			
	UK defined benefit pension schemes £m	US and other pension schemes £m	Other schemes £m	Total £m
Included in operating costs:				
Current service cost	**(177)**	**(11)**	**(18)**	**(206)**
Past service cost – plan amendments	**(4)**	**–**	**–**	**(4)**
	(181)	**(11)**	**(18)**	**(210)**
Administrative expenses	**(14)**	**(21)**	**(1)**	**(36)**
	(195)	**(32)**	**(19)**	**(246)**
Included in net finance costs:				
Net interest expense on post-employment benefit obligations	**(83)**	**(28)**	**(3)**	**(114)**
Group defined benefit schemes included in share of results of equity accounted investments:				
Group's share of equity accounted investments' operating costs	**(9)**	**–**	**–**	**(9)**
Group's share of equity accounted investments' finance costs	**(3)**	**–**	**–**	**(3)**

	2018			
	UK defined benefit pension schemes £m	US and other pension schemes £m	Other schemes £m	Total £m
Included in operating costs:				
Current service cost	(201)	(12)	(1)	(214)
Past service cost – plan amendments	(10)	–	–	(10)
	(211)	(12)	(1)	(224)
Guaranteed Minimum Pension equalisation charge	(110)	–	–	(110)
Administrative expenses	(13)	(14)	(1)	(28)
	(334)	(26)	(2)	(362)
Included in net finance costs:				
Net interest (expense)/income on post-employment benefit obligations	(80)	(24)	1	(103)
Group defined benefit schemes included in share of results of equity accounted investments:				
Group's share of equity accounted investments' operating costs[1]	(15)	–	–	(15)
Group's share of equity accounted investments' finance costs	(3)	–	–	(3)

1. The 2018 Group's share of equity accounted investments' operating costs included £4m relating to the Guaranteed Minimum Pension equalisation charge.

The Group incurred a charge of £226m (2018 £203m) in relation to defined contribution schemes for employees.

23. Post-employment benefits continued

IAS 19 accounting continued

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2019 and keeping all other assumptions as set out on page 204.

Financial assumptions

The estimated impact of changes in the discount rate and inflation assumptions on the defined benefit pension obligation, together with the estimated impact on scheme assets, is shown in the table below. The estimated impact on scheme assets takes into account the Group's risk management activities in respect of interest rate and inflation risk. The sensitivity analysis on the defined benefit obligation is measured on an IAS 19 accounting basis and, therefore, does not reflect the natural hedging in the discount rate used for funding valuation purposes.

	(Increase)/decrease in pension obligation[1] £bn	Increase/(decrease) in scheme assets[1] £bn
Discount rate:		
0.1 percentage point increase	0.5	(0.3)
0.1 percentage point decrease	(0.5)	0.3
Inflation:		
0.1 percentage point increase	(0.4)	0.2
0.1 percentage point decrease	0.3	(0.2)

1. Before allocation to equity accounted investments.

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[1] £bn
Inflation:	
0.5 percentage point increase	(1.5)
0.5 percentage point decrease	1.4
1.0 percentage point increase	(3.0)
1.0 percentage point decrease	2.8

1. Before allocation to equity accounted investments.

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 203), would have the following effect on the total net IAS 19 deficit:

	(Increase)/decrease in net deficit[1] £bn
Life expectancy:	
One-year increase	(1.3)
One-year decrease	1.3

1. Before allocation to equity accounted investments.

24. Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

Warranties and after-sales service
Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of 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 announced to those affected. 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	46	51	294	36	427
Current	58	30	212	34	334
At 1 January 2019	104	81	506	70	761
Transition adjustment upon adoption of IFRS 16 Leases (note 36)	–	–	(31)	–	(31)
Created	65	29	99	14	207
Utilised	(42)	(25)	(57)	(12)	(136)
Arising on business combinations	–	–	–	19	19
Reclassification between categories	–	–	12	(12)	–
Transfer from other balance sheet categories	–	–	24	–	24
Reclassification as held for sale	–	–	(8)	–	(8)
Released	(14)	(31)	(105)	(10)	(160)
Net present value adjustments	–	–	23	3	26
Foreign exchange adjustments	(3)	(2)	(11)	(1)	(17)
At 31 December 2019	**110**	**52**	**452**	**71**	**685**
Represented by:					
Non-current	54	18	266	47	385
Current	56	34	186	24	300
	110	**52**	**452**	**71**	**685**

Warranties and after-sales service
Warranty and after-sales service provisions are generally utilised 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 provisions are generally utilised within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

Other debtors includes £18m (2018 £46m) which is reimbursable in respect of reorganisation costs.

Legal, contractual and environmental
Reflecting the inherent uncertainty within many legal proceedings, the amount of the outflows could differ significantly from the amount provided. While the timing of the outflows is also uncertain, the Group expects these provisions to be utilised over a period of approximately 25 years.

Other
There are no individually significant provisions included within other provisions.

25. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2018, 31 December 2018 and 31 December 2019	**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.

Treasury shares

As at 31 December 2019, 261,897,751 (2018 271,650,137) ordinary shares of 2.5p each with an aggregate nominal value of £6,547,444 (2018 £6,791,253) were held in treasury. During 2019, 9,752,386 (2018 9,582,602) treasury shares were used to satisfy awards and options under the Share Incentive Plan, International Share Incentive Plan, Performance Share Plan, the Performance Shares and Restricted Shares elements of the Long-Term Incentive Plan, and the Executive Share Option Plan.

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 December 2019.

At 31 December 2019, the ESOP held 2,887,846 (2018 2,299,585) ordinary shares of 2.5p each, with a market value of £16m (2018 £11m). 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 December 2019 over shares within the Company's share incentive plan trusts other than those shares owned beneficially by the participants.

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.

Equity dividends

Equity dividends on ordinary share capital are recognised as a liability on the date that the shareholder's right to receive payment is established. This is generally the date that the dividend is declared.

	2019 £m	2018 £m
Prior year final 13.2p dividend per ordinary share paid in the year (2018 13.0p)	**423**	415
Interim 9.4p dividend per ordinary share paid in the year (2018 9.0p)	**301**	288
	724	703

After the balance sheet date, the directors proposed a final dividend of 13.8p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 1 June 2020 to shareholders registered on 17 April 2020. The ex-dividend date is 16 April 2020.

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 7 May 2020.

25. 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 2018	4,589	202	10	3	59	1,227	6,090
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	396	396
Net amounts charged to hedging reserve	–	–	–	–	(25)	–	(25)
Tax on net amounts charged to hedging reserve	–	–	–	–	5	–	5
Equity accounted investments, net of tax	–	–	–	–	(1)	16	15
At 1 January 2019	4,589	202	10	3	38	1,639	6,481
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	(322)	(322)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	–	–	(8)	(8)
Net amounts charged to hedging reserve	–	–	–	–	(1)	–	(1)
Equity accounted investments, net of tax	–	–	–	–	25	(19)	6
At 31 December 2019	**4,589**	**202**	**10**	**3**	**62**	**1,290**	**6,156**

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 2019, the Group's capital was £5,449m (2018 £5,580m), which comprises total equity of £5,511m (2018 £5,618m), excluding amounts accumulated in equity relating to cash flow hedges of £62m (2018 £38m). Net debt was £743m (2018 £904m).

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;
- investing in research and technology and pursuing other 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.

26. Operating business cash flow

Key Performance Indicator – Operating business cash flow
Definition Net cash flow from operating activities excluding taxation and including net capital expenditure and lease principal amounts, financial investment and dividends from equity accounted investments.

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

Taxation is excluded because it is not relevant to the pre-tax operational cash generation of the Group.

Net capital expenditure, lease principal amounts and financial investment are included as a measure of the investment in the business to support the operational performance of the Group.

Dividends received from equity accounted investments are included as a measure of the operating cash generation of the Group's equity accounted investments.

Reconciliation of net cash flow from operating activities to operating business cash flow

	2019 £m	2018 £m
Net cash flow from operating activities	**1,597**	1,200
Add back Taxation paid	**252**	200
Purchase of property, plant and equipment, and investment property	**(360)**	(358)
Purchase of intangible assets	**(110)**	(139)
Proceeds from sale of property, plant and equipment, and investment property	**21**	34
Proceeds from sale of intangible assets	**1**	–
Equity accounted investment funding	**(6)**	(1)
Principal element of lease payments and receipts	**(230)**	–
Net capital expenditure, lease principal amounts and financial investment	**(684)**	(464)
Dividends received from equity accounted investments	**142**	57
Operating business cash flow	**1,307**	993

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, lease principal amounts and financial investment		Net cash flow from operating activities	
	2019 £m	2018 £m	2019 £m	2018 £m	2019 £m	2018 £m	2019 £m	2018 £m
Electronic Systems	**672**	431	**(5)**	(7)	**166**	151	**833**	575
Cyber & Intelligence	**68**	85	**–**	–	**31**	11	**99**	96
Platforms & Services (US)	**241**	(30)	**(17)**	(7)	**81**	68	**305**	31
Air	**408**	666	**(117)**	(36)	**206**	89	**497**	719
Maritime	**150**	67	**(3)**	(3)	**142**	126	**289**	190
HQ	**(232)**	(226)	**–**	(4)	**58**	19	**(174)**	(211)
	1,307	993	**(142)**	(57)	**684**	464	**1,849**	1,400
Taxation paid[1]							**(252)**	(200)
Net cash flow from operating activities							**1,597**	1,200

1. Taxation is managed on a Group-wide basis.

27. Movement in assets and liabilities arising from financing activities

	As at 1 January 2018 £m	Cash (inflow)/ outflow £m	Non-cash movements: Foreign exchange movements £m	Non-cash movements: Fair value and other movements £m	As at 31 December 2018 £m	Recognised on transition to IFRS 16 Leases £m	Cash (inflow)/ outflow £m	Non-cash movements: Foreign exchange movements £m	Non-cash movements: Fair value and other movements £m	As at 31 December 2019 £m
Non-current assets										
Other financial assets[1]	**79**	–	–	41	**120**	–	–	–	(3)	**117**
Current assets										
Other financial assets[1]	**12**	(112)	–	187	**87**	–	(167)	–	87	**7**
	91	(112)	–	228	**207**	–	(167)	–	84	**124**
Non-current liabilities										
Loans	**(4,069)**	–	(229)	784	**(3,514)**	–	–	117	377	**(3,020)**
Lease liabilities	**–**	–	–	–	**–**	(1,270)	–	17	137	**(1,116)**
Other financial liabilities[1]	**(19)**	–	–	10	**(9)**	–	–	–	3	**(6)**
Cash collateral[2]	**(17)**	(2)	–	–	**(19)**	–	(1)	–	–	**(20)**
Current liabilities										
Loans	**(7)**	7	–	(785)	**(785)**	–	782	3	(377)	**(377)**
Lease liabilities	**–**	–	–	–	**–**	(216)	239	1	(262)	**(238)**
Other financial liabilities[1]	**(56)**	106	–	(61)	**(11)**	–	127	–	(174)	**(58)**
	(4,168)	111	(229)	(52)	**(4,338)**	(1,486)	1,147	138	(296)	**(4,835)**
		(1)					**980**			
Interest paid		203					233			
Net sale of own shares		(1)					–			
Equity dividends paid		703					724			
Dividends paid to non-controlling interests		28					56			
Partial disposal of shareholding in subsidiary undertaking[3]		(17)					(31)			
Net cash flow from financing activities[3]		**915**					**1,962**			

1. Excluding cash flow hedges, for which the cash flow is reported within cash flow from operating activities. See note 14 for an analysis of other financial assets and liabilities.
2. Reported in other payables.
3. 2018 comparatives have been reclassified to present a cash inflow of £17m in respect of a partial disposal of the Group's shareholding in a subsidiary undertaking within financing activities. This cash flow was previously presented in investing activities.

28. 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 indebtedness of the Group.

Components of net debt

	Notes	2019 £m	2018 £m
Cash and cash equivalents	18	**2,587**	3,232
Debt-related derivative financial instrument assets – non-current	14	**103**	87
Debt-related derivative financial instrument assets – current	14	**–**	78
Loans – non-current	21	**(3,020)**	(3,514)
Loans and overdrafts – current	21	**(377)**	(785)
Debt-related derivative financial instrument liabilities – non-current	14	**(6)**	–
Debt-related derivative financial instrument liabilities – current	14	**(30)**	(2)
Net debt		**(743)**	(904)

29. 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 money market funds are calculated by multiplying the net asset value per share by the investment held at the balance sheet date.

Due to the variability of the valuation factors, the fair values presented at 31 December may not be indicative of the amounts the Group would expect to realise in the current market environment.

Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

Carrying amounts and fair values of certain financial instruments

		2019		2018	
	Notes	**Carrying amount £m**	**Fair value £m**	Carrying amount £m	Fair value £m
Financial instruments measured at fair value:					
Non-current					
Equity investments at fair value through profit and loss		**13**	**13**	13	13
Other financial assets	14	**350**	**350**	245	245
Other financial liabilities	14	**(227)**	**(227)**	(104)	(104)
Current					
Other financial assets	14	**210**	**210**	166	166
Money market funds	18	**680**	**680**	908	908
Other financial liabilities	14	**(232)**	**(232)**	(74)	(74)
Financial instruments not measured at fair value:					
Non-current					
Loans	21	**(3,020)**	**(3,315)**	(3,514)	(3,597)
Current					
Cash and cash equivalents (excluding money market funds)	18	**1,907**	**1,907**	2,324	2,324
Loans and overdrafts	21	**(377)**	**(380)**	(785)	(794)

All of the financial assets and liabilities measured at fair value are classified as level 2 using the fair value hierarchy, except for money market funds, which are classified as level 1. 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, which are held at amortised cost. The fair value of loans presented in the table above is derived from market prices, classified as level 1 using the fair value hierarchy.

30. 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 109 to 130.

Expense in year

	2019 £m	2018 £m
Executive Share Option Plan	**6**	7
Performance Share Plan	**21**	13
Restricted Share Plan	**7**	7
	34	27

The Group also incurred a charge of £40m (2018 £36m) in respect of the equity-settled all-employee Free Shares and Matching Partnership Shares elements of the Share Incentive Plan.

Executive Share Option Plan

	2019		2018	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**36,164**	**5.44**	32,907	5.28
Granted during the year	**11,610**	**4.89**	8,971	5.83
Exercised during the year	**(4,077)**	**4.62**	(3,174)	4.74
Expired during the year	**(4,718)**	**5.46**	(2,540)	5.60
Outstanding at the end of the year	**38,979**	**5.36**	36,164	5.44
Exercisable at the end of the year	**12,476**	**4.74**	9,482	4.52

	2019	2018
Range of exercise price of outstanding options (£)	**3.01 – 6.49**	3.01 – 6.49
Weighted average remaining contracted life (years)	**7**	7
Weighted average fair value of options granted (£)	**0.64**	0.86

Performance Share Plan and Restricted Share Plan

	Performance Share Plan		Restricted Share Plan	
	2019 Number of shares '000	2018 Number of shares '000	**2019 Number of shares '000**	2018 Number of shares '000
Outstanding at the beginning of the year	**22,380**	20,758	**4,100**	3,769
Granted during the year	**9,653**	7,851	**2,084**	1,540
Exercised during the year	**(964)**	(965)	**(1,305)**	(1,012)
Expired during the year	**(8,574)**	(5,264)	**(473)**	(197)
Outstanding at the end of the year	**22,495**	22,380	**4,406**	4,100
Exercisable at the end of the year	**223**	250	**8**	–

	2019	2018	**2019**	2018
Weighted average remaining contracted life (years)	**5**	5	**5**	5
Weighted average fair value of awards granted (£)	**3.89**	4.63	**4.90**	5.83

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2018 £nil).

30. Share-based payments continued

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

	2019	2018
Range of share price at date of grant (£)	**4.85 – 5.63**	5.82 – 6.07
Expected option/award life (years)	**3 – 10**	3 – 10
Volatility (%)	**19**	19
Risk free interest rate (%)	**0.3**	0.8

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £5.21 (2018 £5.89).

31. Related party transactions

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 12) and pension schemes (note 23).

Transactions with related parties occur 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 parties		Purchases from related parties		Amounts owed by related parties		Amounts owed to related parties[1]		Management recharges[1]	
Related party	**2019 £m**	2018 £m	**2019 £m**	2018[2] £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m	**2019 £m**	2018 £m
Advanced Electronics Company Limited	**41**	38	**215**	166	**–**	18	**35**	24	**–**	–
CTA International SAS	**2**	1	**–**	–	**1**	–	**13**	15	**–**	–
Eurofighter Jagdflugzeug GmbH	**854**	1,028	**248**	313	**41**	37	**42**	52	**–**	–
FADEC International LLC	**114**	101	**–**	–	**–**	–	**–**	–	**–**	–
FAST Training Services Limited	**2**	2	**–**	–	**–**	–	**–**	–	**–**	–
MBDA SAS	**28**	23	**164**	199	**8**	8	**1,041**	864	**19**	18
Panavia Aircraft GmbH	**27**	32	**16**	26	**1**	4	**–**	–	**–**	–
Reaction Engines Limited	**–**	1	**–**	–	**–**	–	**–**	–	**–**	–
Rheinmetall BAE Systems Land Limited	**4**	–	**–**	–	**–**	–	**–**	–	**–**	–
BAE Systems Pension Funds Trustees Limited[3]	**–**	–	**20**	19	**–**	4	**225**	10	**–**	–
Other	**2**	–	**1**	–	**2**	–	**3**	–	**–**	–
	1,074	1,226	**664**	723	**53**	71	**1,359**	965	**19**	18

1. Also relates to disclosures under IAS 24 Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2019, £862m (2018 £869m) was owed by BAE Systems plc and £497m (2018 £96m) by other Group subsidiaries.
2. 2018 purchases from related parties have been restated to include £313m of purchases from Eurofighter Jagdflugzeug GmbH.
3. Transactions with BAE Systems Pension Funds Trustees Limited represent lease arrangements for land and buildings leased by the Group. Amounts owed at 31 December 2019 include £225m in respect of lease liabilities measured under IFRS 16. The undiscounted minimum lease commitments to this related party at 31 December 2018 were £297m, which is not included within amounts owed to related parties in the table above.

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 109 to 130. Total emoluments for directors and key management personnel charged to the Consolidated income statement were:

	2019 £'000	2018 £'000
Short-term employee benefits	**18,163**	15,140
Post-employment benefits	**1,275**	1,127
Share-based payments	**8,538**	6,578
	27,976	22,845

32. 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 24).

The Group believes that any significant liability in respect of its guarantees and performance bond arrangements, and legal actions and claims not already provided for, is remote.

33. Acquisition of subsidiaries

Subsidiaries acquired during 2019
All acquisitions which took place during the year ended 31 December 2019 were immaterial, both individually and collectively.

Subsidiaries acquired during 2018
On 14 December 2018, the Group acquired 100% of the issued share capital of ASC Shipbuilding Pty (ASCS) for consideration of A$1. Following the acquisition, ASCS was awarded the contract for the Australian Hunter Class Future Frigate programme.

The Group determined that it controls ASCS; therefore the acquisition was accounted for as a business combination and its results and financial position have been consolidated from the date of acquisition.

The fair values of the assets and liabilities of ASCS at the date of acquisition were as follows:

	£m
Cash and cash equivalents	14
Trade and other receivables	1
Trade and other payables	(15)
Net identifiable assets acquired	–
Goodwill arising	–
Net assets acquired	**–**

Acquisition-related costs of £1m were included in operating expenses in the Consolidated income statement in the year ending 31 December 2018.

ASCS contributed £1m to the Group's revenue and £nil to the Group's operating profit between the date of acquisition and 31 December 2018.

If ASCS had been acquired on 1 January 2018, the Group's revenue and operating profit would have been £16,904m and £1,604m, respectively, for the year ending 31 December 2018.

34. 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 2019 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. For companies incorporated outside of the United Kingdom, the country of incorporation is shown in the address. No subsidiary undertakings have been excluded from the consolidation.

Subsidiaries – wholly-owned

4219 Lafayette, LLC[1]
4219 Lafayette Center Drive, Chantilly VA 20151, United States

Aerosystems International Limited
Lupin Way, Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Alvis Limited

Alvis Pension Scheme Trustees Limited[2]

Alvis Vickers Limited

Armstrong Whitworth Aircraft Limited[2]

ASC Shipbuilding Pty Limited
Level 2, 80 Flinders Street, Adelaide SA 5000, Australia

Australian Marine Engineering Corporation (Finance) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Avro International Aerospace Limited[2]

BAE Systems (Al Diriyah C4i) Limited[2]

BAE Systems (Aviation Services) Limited

BAE Systems (Canada) Inc.
220 Laurier Avenue West, Suite 1200, Ottawa ON K1P 5Z9, Canada

BAE Systems (Combat and Radar Systems) Limited
4th Floor, St. Paul's Gate, 22-24 New Street, St. Helier JE1 4TR, Jersey

BAE Systems (Consultancy Services) Limited

BAE Systems (Corporate Air Travel) Limited

BAE Systems (CS&SI – Qatar) Limited[2]

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 Four) Unlimited Company
Riverside One, Sir John Rogerson's Quay, Dublin 2, Ireland

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[2]

BAE Systems (Insurance) Limited[3]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems (International) Limited

BAE Systems (Kazakhstan) Limited

BAE Systems (Kuwait) Limited

BAE Systems (Land and Sea Systems) Limited[4]

BAE Systems (Malaysia) Sdn Bhd
Level 25 Menara Hong Leong, No. 6 Jalan Damanlela, Bukit Damansara, 50490 Kuala Lumpur, Malaysia

BAE Systems (MEH) Limited

BAE Systems (Military Air) Overseas Limited

BAE Systems (Nominees) Limited[2]

BAE Systems (Oman) Limited

BAE Systems (Operations) Limited[5]

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 (Vehicles and Equipment) Limited

BAE Systems 2000 Pension Plan Trustees Limited[2]

BAE Systems AB[6]
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Al Diriyah Programme Limited[2]

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 (Connect) A/S
c/o Kromann Reumert, Sundkrogsgade 5, Copenhagen East, 2100, Denmark

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
12/F Ark Mori Building, 1-12-32 Akasaka, Minato-ku, Tokyo, 107-6024, Japan

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
c/o Kromann Reumert, Sundkrogsgade 5, Copenhagen East, 2100, Denmark

BAE Systems Applied Intelligence Canada Inc.
1959 Upper Water Street, Suite 900, Halifax NS B3J 2X2, Canada

BAE Systems Applied Intelligence France SAS
19 Boulevard Malesherbes, 75008, Paris, France

BAE Systems Applied Intelligence GCS Inc.[7]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

BAE Systems Applied Intelligence Inc.[8]
5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States

BAE Systems Applied Intelligence Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence LLC[1]
5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States

BAE Systems Applied Intelligence Malaysia Sdn Bhd
Level 25, Menara Hong Leong, No. 6 Jalan Damanlela, Bukit Damansara, 50490 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[7]
440 Wheelers Farms Road, Suite 202, Milford CT 06461, United States

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[9]
9 Raffles Place #26-01, Republic Plaza, Singapore 048619

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[10]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Holdings Limited[2]
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[5]
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 C-ITS AB
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems China (Exports) Limited

BAE Systems Communications Limited[2]

BAE Systems Communications Solutions, LLC[1]
Knowledge Oasis, Building 4, Second Floor, 0402-Z427, Knowledge Oasis Muscat, PO Box 16, Postal Code 135, Muscat, Oman

BAE Systems Controls Inc.[8]
1098 Clark Street, Endicott NY 13760, United States

BAE Systems Creole Inc.[11]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474, United States

BAE Systems Datagate Holdings Limited

BAE Systems Datagate Limited

BAE Systems Deployed Systems Limited[12]

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[2]

34. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Finance B.V.
c/o IQ-EQ, Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Finance Inc.[7]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Flight Training (Australia) Pty Limited[5]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Funds Management[2,13]

BAE Systems GCS International Limited

BAE Systems Global Combat Systems Bridging Limited

BAE Systems Global Combat Systems Munitions Limited

BAE Systems Global LLC[1]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Hägglunds AB
SE-691 80, Karlskoga, Sweden

BAE Systems Hawaii Shipyards Inc.[7]
3049 Ualena Street, Suite 915, Honolulu HI 96819, United States

BAE Systems Holding GmbH
Hauptstrasse 48, 82433 Bad Kohlgrub, Germany

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 IQ-EQ, Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Holdings Inc.[8]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Holdings International LLC[1]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems IAP Research LLC[1]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Imaging Solutions Inc.[8]
1841 Zanker Road, Suite 50, San Jose CA 95112, United States

BAE Systems India (Homeland Security) Private Limited[14]
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8, New Delhi – 110037, India

BAE Systems India (Services) Private Limited[14]
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8, New Delhi – 110037, India

BAE Systems India (Technology) Private Limited[14]
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8, New Delhi – 110037, India

BAE Systems India (Ventures) Private Limited[14]
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8, New Delhi – 110037, India

BAE Systems Information and Electronic Systems Integration Inc.[2]
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 Integrated System Technologies (KSA) Limited

BAE Systems Integrated System Technologies (Overseas) Limited

BAE Systems Integrated System Technologies GmbH[3]
Hans-Stießberger-Str. 2b, 85540 Haar, Germany

BAE Systems Integrated System Technologies Limited

BAE Systems International Inc.[8]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Jacksonville Ship Repair LLC[1]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Land & Armaments Holdings LLC[1,7]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments Inc.[7]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments L.P.[1]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land Systems (Finance) Limited

BAE Systems Land Systems (Investments South Africa) Limited

BAE Systems Land Systems (Investments) Limited

BAE Systems Land Systems (Logistics) Limited

BAE Systems Land Systems (Ranges) Limited

BAE Systems Land Systems (Singapore Investments) Limited

BAE Systems Land Systems ATF Limited

BAE Systems Land Systems FMTV International Inc.[11]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Land Systems Pinzgauer (Holdings) Limited

BAE Systems Land Systems Pinzgauer 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
Universiteler Mahallesi, Beytepe Lodumlu Köy Yolu Cad. No: 5/348 Çankaya, Ankara, Turkey

BAE Systems Marine (Holdings) Limited

BAE Systems Marine (YSL) Limited

BAE Systems Marine Limited

BAE Systems Norfolk Ship Repair Inc.[7]
750 West Berkley Avenue, Norfolk VA 23523, United States

BAE Systems Oman LLC[1]
PO Box 74, Postal Code 111, Seeb, Oman

BAE Systems Ordnance Systems Inc.[7]
4509 West Stone Drive, Kingsport TN 37660-9982, United States

BAE Systems Overseas Inc.[7]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

BAE Systems Pension Funds CIF Trustees Limited[2]

BAE Systems Pension Funds Investment Management Limited[2,15]

BAE Systems Pension Funds Trustees Limited[2]

BAE Systems Project Services Limited

BAE Systems Projects (Canada) Limited

BAE Systems Properties Limited

BAE Systems Quest Limited[2]

BAE Systems Regional Aircraft (Japan) KK[7]
Minami Azabu T&F Building 8th Floor, 4-11-22 Minami Azabu, Minato-ku, Tokyo, Japan

BAE Systems Regional Aircraft Colombia SAS[16]
c/o Brigard & Urrutia, Calle 70 A No. 4-41, Bogota, Colombia

BAE Systems Resolution Inc.[11]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Rokar International Limited
PO Box 45059, 11 Hartom Street, Mount Hotzvim, 91450 Jerusalem, Israel

BAE Systems S&S Operations Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems San Diego Ship Repair Inc.[7]
2205 East Belt Street, Foot of Sampson Street, San Diego CA 92113, United States

BAE Systems Saudi America Limited
Business Gate Building 7, Floor 1, Riyadh 11482, 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[2]

BAE Systems Saudi Arabia (Vehicles and Equipment Nominees) Limited[2]

BAE Systems Saudi Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

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 Share Plans Trustee Limited[2]

BAE Systems Shared Services (Overseas) Limited

BAE Systems Shared Services Inc.[7]
11215 Rushmore Drive, Charlotte NC 28277, United States

BAE Systems Ship Repair Inc.[7]
750 West Berkley Ave., Norfolk VA 23523, United States

BAE Systems Southeast Shipyards AMHC Inc.[7]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Surface Ships (Holdings) Limited

BAE Systems Surface Ships (Overseas) Limited

BAE Systems Surface Ships (Projects) Limited

BAE Systems Surface Ships Integrated Support Limited

BAE Systems Surface Ships Intermediate Holdings Limited

BAE Systems Surface Ships International Limited[6]

BAE Systems Surface Ships Limited

BAE Systems Surface Ships Maritime Limited

BAE Systems Surface Ships Portsmouth Limited[6]

BAE Systems Surface Ships Projects (Malaysia) Sdn Bhd
Level 14, West Block, Wisma Golden Eagle Realty, 142C, Jalan Ampang, 50450 Kuala Lumpur, Malaysia

BAE Systems Surface Ships Property Services Limited

BAE Systems Surface Ships Support Limited[5]

BAE Systems SWS Defence AB
SE-691 80 Karlskoga, Sweden

BAE Systems Tactical Vehicle Systems LP[1]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Technology Solutions & Services Inc.[7]
520 Gaither Road, Rockville, MD 20850, United States

BAE Systems Training Services Limited

BAE Systems TVS Holdings Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Holdings LLC[1]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Inc.[11]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Zephyr Corporation[8]
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[8]
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[8]
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[8]
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[8]
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, Inc.[7]
1101 Wilson Blvd, Suite 2000, Arlington VA 22209, United States

34. Information about related undertakings continued

Subsidiaries – wholly-owned continued

Brabazon Limited

British Aerospace (Far East) Limited[17]
Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong

British Aerospace (Malaysia) Sdn Bhd[17]
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[2]

British Aircraft Corporation Limited[2]

Buckfield Properties Limited

Cashhold Limited[2,3,5]
15 Canada Square, London E14 5GL, United Kingdom

CPS International, Inc.[11]
c/o Benedetti & Benedetti, Comosa Building, 21st Floor, Ave. Samuel Lewis, PO Box 850120, Panama 5, Panama

Creole (Nigeria) Limited[5]
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[6]
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.
5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States

ETI Engineering, Inc.[7]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

Gloster Aircraft Limited[2]

Granada Enterprises Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

H-B Utveckling, H-B Development AB
Nybrogatan 7, SE-114 34 Stockholm, Sweden

Hadrian Holdings, Inc.[14]
521 Fifth Avenue, New York NY 101075, United States

Hadrian Trustees Limited[2,14]

Hägglunds Vehicle GmbH
Ernst-Grote Strasse 13, 30916 Isernhagen, Germany

Hawker Siddeley Aviation Limited[2]

Hawker Siddeley Dynamics Limited[2]

Hertfordshire Estates Limited[5]

HSA/HSD Pension Fund Trustees Limited[2]

Hunter Aerospace Corporation Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

International Military Sales Limited

Jetstream Aircraft Limited[2]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Lemacrown Limited[18]

MES Holdco Limited
4th Floor, St. Paul's Gate, 22-24 New Street, St. Helier JE1 4TR, Jersey

MES Interco[13]

Meslink Limited

Newcombe Properties Limited

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[19]

Port Solent Marina Limited[19]

PT. BAE Systems Services[7]
Wisma 46, Kota BNI, 34th Floor, Suite 34.01.A, Jl. Jenderal Sudirman Kavling 71, Jakarta 10220, Indonesia

Representaciones SSTS, CA[11]
Ave Francisco de Miranda, Centro Lido El Rosal Oficina 71B, Caracas, Venezuela

Riptide Autonomous Solutions Canada Company
1300-1969 Upper Water Street, Purdy's Wharf Tower II, Halifax, NS, BJ3 3R7, Canada

Royal Ordnance (Crown Service) Pension Scheme Trustees Limited

Royal Ordnance B.V.
c/o IQ-EQ, Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Royal Ordnance Senior Staff Pension Scheme Trustees Limited

Royal Ordnance Speciality Metals Limited[2]

RWT Limited[2]

Salford Electrical Instruments Limited

Scentcivil Limited

Scottish Aviation Limited[2]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Sepia, LLC[1]
4219 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

Silversky Technology Sdn. Bhd.
Level 25, Menara Hong Leong, No. 6 Jalan Damanlela, Bukit Damansara, 50490 Kuala Lumpur, Malaysia

Stewart & Stevenson Operations (Nigeria) Limited[11]
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[1,16]
House No. 145, Street No. 1, Qtr. 611, Al Andulous Area, Al Mansour, Baghdad, Iraq

TDS International Holdings Pty Limited[20]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

TDS International Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

The Blackburn Aeroplane & Motor Co Limited[2]

The Bristol Aviation Company Limited[2]

The British & Colonial Aeroplane Co. Limited[2]

The Leeds Partnership Limited[5]

The Supermarine Aviation Works Limited[2,4]

Thomas Sopwith Aviation Company Limited[2]

VSEL Birkenhead Limited

Warship Design Services Limited

Westover Controls Incorporated[7]
1098 Clark Street, Endicott NY 13760, United States

34. Information about related undertakings continued

Subsidiaries – not wholly-owned

Advanced National Company for Aircraft Maintenance Limited (76.5%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Aircraft Research Association Limited (92.8%)[2]
Manton Lane, Bedford MK41 7PF, United Kingdom

BAE Systems Saudi Development and Training Company Limited (74.9%)[21]
PO Box 67775, Riyadh 11517, Saudi Arabia

BAE Systems SDT (UK) Limited (74.9%)

Flight Control System Management GmbH (66.6%)[22]
PO Box 801109, 81663 Munich, Germany

Hadrian Properties, Inc. (95%)[14]
521 Fifth Avenue, New York NY 101075, United States

International Systems Engineering Company Limited (69.3%)
PO Box 54002, Riyadh 11514, Saudi Arabia

Overhaul and Maintenance Company Holding (76.5%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Prismatic Limited (51%)
2 Omega Park, Alton GU34 2QE, United Kingdom

Saudi Maintenance & Supply Chain Management Company Limited (51%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Technology & Logistics Services Limited (65%)[2]
PO Box 1732, Riyadh 11441, Saudi Arabia

SMSCMC (UK) Limited (51%)

Equity accounted investments

Abercromby Property International (20.42%)
521 Fifth Avenue, New York NY 101075, United States

Advanced Electronics Company Limited (38.2%)
PO Box 90916, Riyadh 11623, Saudi Arabia

Air Astana (49%)[8]
121 Kabanbay Batyr Avenue, Yessil District, Astana 010000, Kazakhstan

AMSH B.V. (50%)[23]
Weena 210-212, 3012 NJ Rotterdam, Netherlands

BAE Systems Strategic Aerospace Services WLL (49%)
Building 52, Floor 2, Area 23, Qatari Bin Al Fajaa, Doha, Qatar

BAeHAL Software Limited (40%)[2,14]
Airport Lane, HAL Estate, Bangalore 560010, India

BHIC Bofors Defense Asia Sdn Bhd (49%)
Level 21, Suite 21.01, The Gardens South Tower, Mid Valley City, Lingkaran Syed Putra, 59200 Kuala Lumpur, Malaysia

Canadian Naval Support Limited (50%)[24]
3099 Barrington Street, Halifax NS B3K 5M7, Canada

CTA International SAS (50%)
13 Route De La Miniere, 78034 Versailles Cedex, France

Data Link Solutions L.L.C. (50%)[1,17]
400 Collins Ave, Cedar Rapids IA 52498, United States

Eurofighter Aircraft Management GmbH (33%)[2,16]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Eurofighter Jagdflugzeug GmbH (33%)[2]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

European Aerosystems Limited (50%)[2,20]

FADEC International LLC (50%)[1]
1098 Clark Street, Endicott NY 13760, United States

FAST Holdings Limited (50%)[14,20]

FAST Training Services Limited (50%)[14]

FNSS Savunma Sistemleri A.S (49%)[20]
Oğulbey Mahallesi, Oğulbey Kumeevleri, No. 441/A, 441/B, Gölbaşı, Ankara, Turkey

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%)[23]
Üniversiteler Mah, 1605.Cad, No:3/1-3, 06800, Ankara, Turkey

Panavia Aircraft GmbH (42.5%)[2]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Rheinmetall BAE Systems Land Limited (45%)
Hadley Castle Works, PO Box 106, Telford TF1 6QW, United Kingdom

Saab Bofors Test Center AB (30%)
SE-691 80 Karlskoga, Sweden

Saab-BAe Systems Gripen AB (50%)[2,3]
SE-581 88 Linköping, Sweden

Sealand Support Services Limited (33.3%)[10]
MoD Sealand, Welsh Road, Sealand, Deeside, Flintshire CH5 2LS, United Kingdom

Spectrum Technologies Limited (20%)[2,14]
Western Avenue, Bridgend Industrial Estate, Bridgend, Mid Glamorgan CF31 3RT, United Kingdom

Winner Developments Limited (33.3%)

Notes

1. Unincorporated entity for which the address given is the principal place of business.
2. Directly owned by BAE Systems plc.
3. In members' voluntary liquidation.
4. Ownership held in class of A shares, B shares and preference shares.
5. Ownership held in class of A shares and B shares.
6. Ownership held in ordinary shares and preference shares.
7. Ownership held in common shares.
8. Ownership held in common stock.
9. Year end 30 June.
10. Ownership held in ordinary shares and redeemable preference shares.
11. Ownership held in authorized shares.
12. 40% owned by BAE Systems plc.
13. Unlimited company.
14. Year end 31 March.
15. Year end 5 April.
16. In liquidation.
17. Year end 30 September.
18. Ownership held in ordinary shares and class of A shares.
19. In strike off.
20. Ownership held in class of A shares.
21. 1% owned by BAE Systems plc.
22. 33.3% owned by BAE Systems plc.
23. Ownership held in class of B shares.
24. Ownership held in common shares and B Preferred shares.

35. Events after the reporting period

In January 2020, the Group announced that it has entered into a definitive Asset Purchase Agreement to acquire Collins Aerospace's Military Global Positioning System business for $1.9bn in cash, subject to customary closing adjustments. The Group has also entered into a definitive Asset Purchase Agreement to acquire Raytheon's Airborne Tactical Radios business for $275m in cash, subject to customary closing adjustments. Completion of both acquisitions is subject to successful closure of the Raytheon-United Technologies Corporation merger, as well as customary regulatory approvals and conditions.

In October, six of the Group's nine UK pension schemes (including the two largest schemes) were consolidated into a single scheme. Following that consolidation, the Company agreed with the new Trustee Board to bring forward the funding valuation of the combined scheme to 31 October 2019 from the previously scheduled date of 31 March 2020.

After consultation with The Pensions Regulator in the UK, the Group has reached agreement with the Trustee Board of the combined scheme on the accelerated funding valuation and revised deficit recovery plan.

At the 31 October 2019 funding valuation date, the deficit was £1.9bn. The current deficit recovery plan which runs to 2026 will be replaced by a new deficit recovery plan, under which a one-off payment of £1bn is to be made in the coming months, with approximately £240m of funding payable in the scheme year ending 31 March 2020 and approximately £250m by 31 March 2021.

36. Adoption of IFRS 16 Leases

IFRS 16 became effective from 1 January 2019 and has replaced IAS 17 Leases and related interpretations. It has resulted in almost all leases being recognised on the balance sheet by lessees, as the distinction between operating and finance leases is removed. Under the new standard, a right-of-use asset and a financial liability for future lease payments are recognised. The only exceptions are short-term leases, low-value leases and leases of intangible assets.

The Group has applied the modified retrospective transition approach and has not restated comparative amounts for the year ended 31 December 2018. In the majority of cases the Group has elected to measure right-of-use assets at the amount of the lease liability on adoption (adjusted for any lease prepayments or accrued lease expenses, onerous lease provisions, and leased assets which have subsequently been subleased). For a number of property leases the Group has elected to measure the right-of-use asset as if IFRS 16 had been applied since the start of the lease, but using the incremental borrowing rate at 1 January 2019, with the difference between the right-of-use asset and the lease liability taken to retained earnings.

The Group has elected to adopt the following practical expedients on transition:

– not to capitalise a right-of-use lease asset or related lease liability where the lease expires before 31 December 2019;
– not to reassess contracts to determine if the contract contains a lease and not to separate lease and non-lease elements;
– where an onerous lease provision is in existence, to utilise this provision to reduce the right-of-use asset value rather than undertaking an impairment review;
– to use hindsight in determining the lease term;
– to exclude initial direct costs from the measurement of the right-of-use asset; and
– to apply the portfolio approach where a group of leases has similar characteristics.

Impact of adoption of IFRS 16 Leases

Balance sheet

Upon transition on 1 January 2019, the Group recognised a right-of-use lease asset of £1,298m (after adjustments for onerous lease provisions, lease prepayments and accrued lease expenses at 31 December 2018), and lease liabilities of £1,486m (non-current £1,270m; current £216m), along with a deferred tax asset of £2m. A sublease finance receivable of £72m was also recognised. A transition adjustment of £92m was recognised as a debit to retained earnings. The Group did not capitalise low-value leases on transition, or those which expire before 31 December 2019, and has opted not to apply IFRS 16 to leases relating to intangible assets. The right-of-use lease asset principally consists of property.

Income statement

Under IFRS 16 the Group sees a different pattern of expense within the income statement, as the IAS 17 operating lease expense is replaced by depreciation and interest charges. In 2019, the Group's EBITA metric has improved by approximately £50m under IFRS 16 as the new depreciation expense is lower than the IAS 17 operating lease charge; however the new finance costs have broadly offset this, such that net profit after tax and the underlying earnings metrics are not materially different compared to the previous IAS 17 reporting basis.

Cash flow statement

The change in presentation as a result of the adoption of IFRS 16 has seen an improvement in 2019 of approximately £46m in operating business cash flow, offset by a corresponding decline in cash flow from financing activities. There is no overall cash flow impact from the adoption of the new Standard.

Lessor accounting under IFRS 16 is largely unchanged from IAS 17.

Accounting policy

The accounting policy in respect of leases applied from 1 January 2019 is set out in note 10.

36. Adoption of IFRS 16 Leases continued

Impact on Consolidated balance sheet at 1 January 2019 (extract)
The following table shows the effect of adopting IFRS 16 on the Consolidated balance sheet at 1 January 2019.

	£m
Non-current assets	
Right-of-use assets	1,255
Investment property	43
Equity accounted investments	(11)
Finance lease receivable	62
Deferred tax assets	2
	1,351
Current assets	
Finance lease receivable	10
Trade, other and contract receivables	(26)
	(16)
Total assets	**1,335**
Non-current liabilities	
Lease liabilities	(1,270)
Provisions	24
	(1,246)
Current liabilities	
Lease liabilities	(216)
Trade and other payables	28
Provisions	7
	(181)
Total liabilities	**(1,427)**
Net assets	**(92)**
Capital and reserves	
Retained earnings	(92)
Total equity attributable to equity holders of BAE Systems plc	**(92)**
Non-controlling interests	**–**
Total equity	**(92)**

The weighted average incremental borrowing rate applied to lease liabilities was 3.4%.

Reconciliation between operating lease commitments and lease liability
The following table explains the difference between the operating lease commitments disclosed applying IAS 17 at 31 December 2018 and the lease liability recognised on adoption of IFRS 16 at 1 January 2019.

	£m
Total minimum lease payments reported at 31 December 2018 under IAS 17	1,706
Change in assessment of lease term under IFRS 16	107
Leases outside the scope of IFRS 16	(81)
Impact of discounting lease liability under IFRS 16	(246)
Lease liability recognised on transition to IFRS 16 at 1 January 2019	**1,486**

Company statement of comprehensive income for the year ended 31 December

	2019 £m	2018 £m
Profit for the year	**874**	890
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Remeasurements on post-employment benefit schemes	**(99)**	(27)
Items that may be reclassified to the income statement:		
Amounts credited to hedging reserve	**1**	2
Total other comprehensive income for the year (net of tax)	**(98)**	(25)
Total comprehensive income for the year	**776**	865

Company statement of changes in equity for the year ended 31 December

	Notes	Issued share capital £m	Share premium £m	Other reserves £m	Retained earnings[1] £m	Total equity £m
At 1 January 2018		87	1,249	203	2,600	4,139
Profit for the year		–	–	–	890	890
Total other comprehensive income for the year		–	–	2	(27)	(25)
Total comprehensive income for the year		–	–	2	863	865
Share-based payments	10	–	–	–	69	69
Net sale of own shares		–	–	–	1	1
Ordinary share dividends[2]		–	–	–	(703)	(703)
At 31 December 2018		87	1,249	205	2,830	4,371
Profit for the year		–	–	–	874	874
Total other comprehensive income for the year		–	–	1	(99)	(98)
Total comprehensive income for the year		–	–	1	775	776
Share-based payments	10	–	–	–	75	75
Ordinary share dividends[2]		–	–	–	(724)	(724)
At 31 December 2019		**87**	**1,249**	**206**	**2,956**	**4,498**

1. The non-distributable portion of retained earnings is £767m (2018 £707m).
2. Details of ordinary share dividends are provided in note 25 to the Group accounts.

Company balance sheet as at 31 December

	Notes	2019 £m	2018 £m
Non-current assets			
Intangible assets		**61**	62
Property, plant and equipment		**10**	13
Right-of-use assets		**27**	–
Investments in subsidiary undertakings and participating interests	2	**8,987**	8,497
Other receivables		**3**	3
Post-employment benefit surpluses	8	**49**	44
Other financial assets	4	**496**	278
		9,633	8,897
Current assets			
Trade and other receivables	3	**3,162**	3,102
Current tax		**14**	14
Other financial assets	4	**307**	207
Cash and cash equivalents		**1,763**	2,563
		5,246	5,886
Total assets		**14,879**	14,783
Non-current liabilities			
Loans	5	**(1,075)**	(1,102)
Lease liabilities		**(29)**	–
Other payables		**(21)**	(22)
Post-employment benefit obligations	8	**(361)**	(228)
Other financial liabilities	4	**(385)**	(164)
Provisions	7	**(126)**	(105)
		(1,997)	(1,621)
Current liabilities			
Lease liabilities		**(1)**	–
Trade and other payables	6	**(8,007)**	(8,645)
Other financial liabilities	4	**(356)**	(126)
Provisions	7	**(20)**	(20)
		(8,384)	(8,791)
Total liabilities		**(10,381)**	(10,412)
Net assets		**4,498**	4,371
Capital and reserves			
Issued share capital		**87**	87
Share premium		**1,249**	1,249
Other reserves	9	**206**	205
Retained earnings[1]		**2,956**	2,830
Total equity		**4,498**	4,371

1. The Company's profit for the year is £874m (2018 £890m).

Approved by the Board of BAE Systems plc on 19 February 2020 and signed on its behalf by:

C N Woodburn
Chief Executive

P J Lynas
Group Finance Director

Registered number: 1470151

Notes to the Company accounts

1. Preparation

Basis of preparation

The financial statements of BAE Systems plc have been prepared on a going concern basis, as discussed in the Directors' report on page 90, and in accordance with Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework.

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 requirements of the second sentence of paragraph 110 and paragraphs 113(a), 114, 115, 118, 119(a) to (c), 120 to 127 and 129 of IFRS 15 Revenue from Contracts with Customers;
- 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 and Company balance sheet.

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.

The Company recognises an increase in its investments in subsidiary undertakings in respect of the cost of share-based payment awards issued by the Company to employees of the Company's operating subsidiaries, with a corresponding entry to equity.

Amounts owed by subsidiary undertakings

Amounts owed by subsidiary undertakings are stated at amortised cost including a provision for expected credit losses. The Company measures the provision at an amount equal to lifetime expected credit losses, but this is not material to the financial statements as the probability of default is insignificant.

Other significant accounting policies

Other significant accounting policies are consistent with the Group accounts.

Judgements and sources of estimation uncertainty

In the course of preparing the financial statements, no judgements have been made in the process of applying the Company's accounting policies, other than those involving estimates, that have had a significant effect on the amounts recognised in the financial statements.

There are no major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Changes in accounting policies

IFRS 16 Leases became effective on 1 January 2019 as described in note 36 to the Group accounts. The impact on the Company accounts was not material.

Several other standards, interpretations and amendments to existing standards became effective on 1 January 2019, as detailed on page 159 of the Group accounts, none of which had a material impact on the Company.

2. Investments in subsidiary undertakings and participating interests

	£m
Cost	
At 1 January 2019	8,516
Additions	490
At 31 December 2019	**9,006**
Impairment provisions	
At 1 January and 31 December 2019	**19**
Net carrying value	
At 31 December 2019	**8,987**
At 31 December 2018	8,497

3. Trade and other receivables

	2019 £m	2018 £m
Current		
Amounts owed by subsidiary undertakings[1]	**3,092**	3,026
Amounts owed by Group joint ventures	**6**	7
Prepayments and accrued income	**39**	56
Other receivables	**25**	13
	3,162	3,102

1. Amounts owed by subsidiary undertakings are repayable on demand. Whilst the majority of these receivables are interest free, certain balances bear interest priced on an arm's-length basis.

4. Other financial assets and liabilities

	2019		2018	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Other foreign exchange/interest rate contracts	**393**	**(379)**	191	(164)
Debt-related derivative financial instruments	**103**	**(6)**	87	–
	496	**(385)**	278	(164)
Current				
Cash flow hedges – foreign exchange contracts	**1**	**–**	–	–
Other foreign exchange/interest rate contracts	**306**	**(326)**	129	(126)
Debt-related derivative financial instruments	**–**	**(30)**	78	–
	307	**(356)**	207	(126)

Disclosures in respect of the fair value of other financial assets and liabilities are provided in note 29 to the Group accounts.

5. Loans

	2019 £m	2018 £m
Non-current		
US$500m 4.75% bond, repayable 2021	**377**	392
£400m 4.125% bond, repayable 2022	**399**	399
US$400m 5.8% bond, repayable 2041	**299**	311
	1,075	1,102

6. Trade and other payables

	2019 £m	2018 £m
Current		
Amounts owed to subsidiary undertakings[1]	**6,909**	7,555
Amounts owed to Group joint ventures	**862**	869
Accruals and deferred income	**156**	140
Other payables	**80**	81
	8,007	8,645

1. Amounts owed to subsidiary undertakings are repayable on demand. Whilst the majority of these payables are interest free, certain balances bear interest priced on an arm's-length basis.

7. Provisions

	Contractual and other £m
Non-current	105
Current	20
At 1 January 2019	125
Created	24
Utilised	(5)
Released	(1)
Net present value adjustments	3
At 31 December 2019	**146**
Represented by:	
Non-current	126
Current	20
	146

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, but the amount of the outflows could differ significantly from the amount provided and the timing of the outflows cannot be estimated reliably.

8. Post-employment 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 23 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.

	2019 £m	2018 £m
Present value of unfunded obligations	**(79)**	(62)
Present value of funded obligations	**(1,965)**	(1,292)
Fair value of scheme assets	**1,732**	1,170
Company's share of net IAS 19 deficit	**(312)**	(184)
Represented by:		
Post-employment benefit surpluses	**49**	44
Post-employment benefit obligations	**(361)**	(228)
	(312)	(184)

9. Share capital and other reserves

Share capital

Disclosures in respect of the Company's share capital are provided in note 25 to the Group accounts.

Other reserves

	Statutory reserve £m	Capital redemption reserve £m	Hedging reserve £m	Total £m
At 1 January 2018	202	3	(2)	203
Amounts credited to hedging reserve	–	–	2	2
At 31 December 2018	202	3	–	205
Amounts credited to hedging reserve	–	–	1	1
At 31 December 2019	**202**	**3**	**1**	**206**

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.

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 109 to 130.

	2019		2018	
	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 – 6.49**	**8**	3.01 – 6.49	8
Performance Share Plan	**–**	**5**	–	5

The average share price in the year was £5.21 (2018 £5.89).

11. Employees

The total number of employees of the Company at 31 December 2019 was 1,729 (2018 1,509). All of the Company's employees work within the Group's HQ segment.

Total staff costs, excluding charges for share-based payments, were as follows:

	2019 £m	2018 £m
Wages and salaries	**113**	103
Social security costs	**13**	11
Pension costs – defined contribution plans	**5**	3
Pension costs – defined benefit plans	**21**	21
	152	138

12. Other information

Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £2,032,000 (2018 £2,000,000). Fees payable to Deloitte LLP and its associates for non-audit services to the Company are not required to be disclosed because the Group accounts disclose such fees on a consolidated basis (see note 2 to the Group accounts).

Related party transactions

Disclosures in respect of related party transactions are provided in note 31 to the Group accounts.

The Company also has amounts receivable from Aircraft Research Association Limited of £3m (2018 £4m) which is a partially-owned subsidiary.

The Company had amounts receivable from Aircraft Accessories and Components Co Limited (AACC) of £9m at 31 December 2018.

In January 2019, as part of a planned reorganisation of the Company's portfolio of interests in a number of industrial companies in Saudi Arabia, the Company's Overhaul and Maintenance Company (OMC) subsidiary disposed of its 85.7% shareholding in AACC to Saudi Arabian Military Industries (SAMI). As a result, AACC is not a related party at 31 December 2019.

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 £9,059,747 (2018 £6,997,880); 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 2019 as at the date of exercise was £140,961 (2018 £113,745) and the net aggregate value of assets received by directors in 2019 from Long-Term Incentive Plans as calculated at the date of vesting was £891,314 (2018 £908,911); 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 one director in respect of defined benefit schemes and to two directors in respect of defined contribution schemes.

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £2,322m (2018 £3,197m), 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 34 to the Group accounts.

Shareholder information

Registered office
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London
SW1Y 5AD
United Kingdom

Telephone: +44 (0)1252 373232

Company website: **baesystems.com**

Registered in England and Wales, No. 1470151

Registrars
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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 email 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.

JP Morgan Chase Bank N.A. is the depositary. If you should have any queries please contact:

JP Morgan Chase Bank N.A.
PO Box 64504
St Paul
MN 55164-0504, USA

Email: **jpmorgan.adr@eq-us.com**

Telephone (toll free from within US and Canada): +1 800 990 1135

Telephone from outside US and Canada: +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 email: **help@sharegift.org**

Share price information
The middle market price of the Company's ordinary shares on 31 December 2019 was 564.8p and the range during the year was 443.9p to 588.2p.

For more information
Visit the Shareholder information section of our website: **investors.baesystems.com**

Financial calendar	
Financial year end	31 December
Annual General Meeting	7 May 2020
2019 final ordinary dividend payable	1 June 2020
2020 half-yearly results announcement	30 July 2020
2020 interim ordinary dividend payable	30 November 2020
2020 full-year results: – preliminary announcement – Annual Report	 February 2021 March 2021
2020 final ordinary dividend payable	June 2021

Beware of share fraud

Investment scams are often sophisticated and difficult to spot.

Spot the warning signs

Fraudsters will often:

- contact you out of the blue;
- apply pressure to invest quickly;
- downplay the risks to your money;
- promise tempting returns that sound too good to be true; and
- say that they're only making the offer available to you or even ask you to not tell anyone else about it.

If you're suspicious, report it

You can report the firm or scam to the FCA by contacting their **Consumer Helpline** on **0800 111 6768** or using the reporting form using the link shown below.

If you've lost money in a scam, contact Action Fraud on **0300 123 2040** or **www.actionfraud.police.uk**

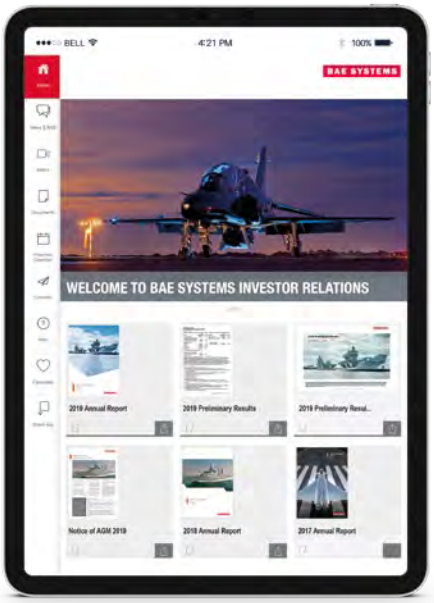
How to avoid investment scams

Reject unexpected offers
Scammers usually cold call, but contact can also come by email, post, word of mouth or at a seminar. If you've been offered an investment out of the blue, chances are it's a high risk investment or a scam.

Check the FCA Warning List
Use the FCA Warning List to check the risks of a potential investment – you can also search to see if the firm is known to be operating without their authorisation.

Get impartial advice
Get impartial advice before investing – don't use an adviser from the firm that contacted you.

Be ScamSmart and visit
www.fca.org.uk/scamsmart



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Designed and produced by Radley Yeldar.

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