

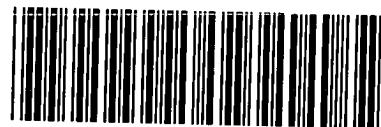
BAE Systems (Operations) Limited

Annual Report and Financial Statements

31 December 2019

Registered Number: 01996687

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Contents

Strategic Report	3
Directors' Report	9
Directors' Responsibilities Statement	13
Independent Auditor's Report to the Members of BAE Systems (Operations) Limited	14
Income Statement	16
Statement of Comprehensive Income	16
Balance Sheet	17
Statement of Changes in Equity	18
Notes to the Financial Statements	19

Strategic Report

BAE Systems (Operations) Limited (the Company) consists of the majority of the BAE Systems Group's Air sector (primarily US Programmes, European and International, and Saudi Arabian businesses), the Group's Electronic Systems business based in Rochester, UK, and elements of the Group's UK Shared Services business.

Review of business

During 2019, the Company remained focused on the execution of its long-term contracted positions in the UK, US and the Middle East.

The UK is Europe's largest defence market. The UK government has stated its commitment to meeting the NATO commitment of spending at least 2% of Gross Domestic Product on defence and to increasing the defence budget by at least 0.5% above inflation, in every year of the current parliament. The government is also expected to recommence an Integrated Foreign Policy, Defence and Security Review later this year after it was paused owing to COVID-19.

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. The next phase of the Tempest technology maturation programme has now been 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 2019, and a Statement of Intent between the UK and Italy in September 2019, committing the respective governments to working with the UK government to develop next-generation combat air capability.

Royal Air Force accepted their final three Typhoon aircraft from the UK final assembly facility, and 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.

In the year, the UK Tornado fleet was retired from service on schedule, following the declaration, in December 2018 by the Royal Air Force that Typhoon had met Centurion standard which enabled the transition of capabilities from Tornado to Typhoon.

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

In the UK, under a ten-year partnership arrangement, the Company continued to support the UK Typhoon fleet to achieve customer target flying hours in 2019. The Company continues to support the European Partner Nations' own support arrangements.

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.

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

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 towards full-rate production levels, which is expected in 2021. 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, the Company continues to support the customer in integrating the F-35 into its operational fleet and forward deployments.

The Company 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.

The Company continues to address current and potential new requirements as part of long-standing agreements between the UK government and the Saudi Arabian government as it continues to work on the localisation of defence capabilities in Saudi Arabia, in support of their National Transformation Plan and Vision 2030. The Company continued with its long term strategy to transfer capability, including employees to joint venture partner companies in Saudi Arabia.

Strategic Report (continued)

The Company 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, the Company is 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 the Company 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.

The Company continues to 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 Company has relatively limited UK-EU trading and movement of EU nationals into and out of the Company's business.

Key performance indicators

Key financial performance indicators are shown below:

	2019	2018
	£	£
Order intake	3.2bn	11.4bn
Revenue	5.6bn	5.0bn
Operating profit	316m	434m

Order intake represents funded orders received from customers in the year.

Revenue represents the income derived from the provision of goods and services.

Operating profit represents profit for the year before income from subsidiary undertakings and participating interests, net finance costs and taxation expense.

The decrease in order intake is primarily due to a return to a more normal order intake level. 2018 order intake included the significant orders of the Qatar Typhoon and Hawk aircraft and support package, and the Saudi Arabian Typhoon support continuation contract.

Strategic Report (continued)

Principal risks

The Company's principal risks are identified below.

The Company is dependent on defence spending.

The Company's core businesses are primarily defence-related, selling products and services directly and indirectly, mainly to governments.

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 Company's principal markets, in particular in the UK.

The Company's largest customers are governments.

The Company has long-standing relationships and security arrangements with a number of its government customers, including the governments of the 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. 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 Company'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.

The Company operates in international markets.

The Company conducts business in a number of regions, including 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 taxes or tariffs; change of export control and other government policy and regulations in the UK 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 Company is exposed to volatility in currency exchange rates, particularly in respect of the Saudi riyal, US dollar and the Euro.

The terms of the UK's relationship with the EU after the end of the Transition Period are currently uncertain, rendering it difficult for the Company 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 Company's ability to take part in collaborative industrial programmes in Europe could encounter new EU barriers.

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

The Company's business plan is targeting an increasing level of business in international export markets.

With constraints on defence spending in the UK, the Company's business and future results may be adversely impacted if it is unable to compete adequately and obtain new business in international markets.

Strategic Report *(continued)*

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

The Company operates in a highly-regulated environment across a number of 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 Company maintains a culture in which it focuses on embedding responsible business behaviours and that all employees act in accordance with the requirements of the Company'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 Company being unable to obtain or maintain necessary export licences.

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

A significant portion of the Company'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 Company 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 Company is dependent on the award timing and cash profile of its contracts.

The Company'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.

The defined benefit pension schemes in which the Company participates have aggregate funding deficits.

In aggregate, there is an actuarial deficit between the value of the projected liabilities of the defined benefit pension schemes in which the Company participates 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.

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

The security threats faced by the Company 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.

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

The Company's 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 Company's business plan is targeting an increasing level of business in international export markets outside the UK. It is important that the Company recruits and retains management with the necessary international skills and experience in the relevant jurisdictions.

The outbreak of contagious diseases may have a material adverse effect on the Company's business, financial condition and results of operations.

Contagious diseases can have an adverse effect on the Company's business, financial condition and results of operations. There is currently a COVID-19 coronavirus pandemic across the world. Governments are taking a number of steps to mitigate the impact of this pandemic, including implementing quarantines. Many people have contracted the disease across the world and many deaths have occurred. It is not clear for how long this pandemic will last or how much more extensive it will become, or the further measures that will be taken by governments and others to seek to control this pandemic and its impact.

Since the outbreak of the COVID-19 coronavirus pandemic, the Company has taken a number of responsive measures including reducing site operational levels and introducing new cleaning regimes, safe working distance measures and protective equipment for its employees. A significant proportion of the Company's employees are working remotely. While the Company is liaising closely with its customers and suppliers to understand any changes in requirements and priorities during this time, the uncertainties surrounding the development of this pandemic make it difficult to predict the extent to which the Company may be affected.

Strategic Report (*continued*)

The COVID-19 coronavirus pandemic could also result in changes to the outlook in the Company's markets. Areas of the Company's business that could be impacted include a decrease in defence spending by the Company's major customers, the failure to obtain awards for defence contracts, the failure of suppliers to deliver parts to the Company, the requirement for the Company or its suppliers to close plants, the inability of the Company to meet contractual delivery requirements on time, the inability to adequately staff and manage the business, and an increase in the cost or lack of availability of funding. If the Company were unable to obtain appropriate funding, it could be forced to make reductions in spending, seek to extend payment terms with suppliers and/or suspend or curtail planned programmes. Any of the above could have a material adverse effect on the Company's business, financial condition and results of operations.

Section 172(1) statement

This statement contains an overview of how the Directors have performed their duty to promote the success of the Company as set out in section 172(1) of the UK's Companies Act 2006. That section requires a Director of a company to act in the way he considers, in good faith, would most likely promote the success of the company for the benefit of its shareholders. In doing this, the Director must have regard, amongst other matters, to:

- 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.

Decision Making

The Operational Framework sets out the principles of good governance to which BAE Systems Group subsidiaries are required to adhere, together with BAE Systems Group's values, policies and processes. Decisions affecting a subsidiary are required to be taken in line with the Operational Framework, including in accordance with applicable delegations of authority.

Pursuant to the Operational Framework, BAE Systems' businesses each produce a strategic plan, a financial forecast for the current year and financial projections for the next five years. The Directors of the Company contribute towards this process for the respective businesses of the Company for which they are responsible and are also responsible for identifying and managing principal and emerging risks in such businesses. In so doing the Directors have regard to a variety of matters including the interests of various stakeholders, the consequences of their decisions in the long term and the long-term reputation of the Company and its businesses.

During the year, the Directors of the Company approved bids and contracts for the businesses for which they are responsible and in so doing, in accordance with BAE Systems Group policies and processes, had regard to a number of matters including the business case and financial returns, technical and programme management matters, risk management, workforce matters and the long term reputation of the Company.

Employees

Employee engagement is a primary focus for the Directors of the Company – connecting employees to the Company's and the BAE Systems Group's strategy and purpose, empowering them to contribute to improving business performance and creating an environment in which everyone can fulfil their potential. As well as keeping the Company's employees informed about what is happening across the BAE Systems Group through the Group's intranet and email, podcasts, newsletters, and leadership blogs and briefings, the Directors place significant focus on engaging and consulting with our employees and their Trade Union/employee representative groups. Notable examples in 2019 included engagement on pension augmentation along with the closure of the rationalisation programme at Warton and the ongoing rationalisation at Brough.

These engagement activities form part of the Company's implementation of the BAE Systems Group-wide employee processes and policies which are described on pages 35-36, 83, 95-98 and 116 of BAE Systems plc's Annual Report 2019 (available at: www.baesystems.com/investors). Pursuant to the Group's People Policy, Directors and employees are required to contribute to creating an engaged and inclusive work environment where individuals are respected and where the value of a diverse workforce is recognised. Also, pursuant to the Policy, employees are to be provided with the means to give their views and feedback.

Through the implementation by the Company of these processes and policies, the Directors have regard to the interests of the Company's employees.

Strategic Report (continued)

Fostering business relationships with suppliers, customers and others

The Directors recognise that fostering business relationships with key stakeholders, such as customers and suppliers, is essential to the Company's success. The Company has close relationships with its customers, suppliers and industry partners which help us to create best-in-class, cost-effective equipment, goods, services and solutions.

Our largest customers are governments and we also sell to large prime contractors. Strong and collaborative relationships with our principal government customers help us to identify our customers' requirements and to help position the Company as a trusted provider. The Managing Director and the Chief Operating Officer of the main business of the Company, who are both Directors of the Company, are in regular contact with the principal government customers of the Company, in particular the governments of the United Kingdom, Saudi Arabia, Qatar and the US.

The Company, together with its procurement and supply chain function, works with its suppliers and their supply chains to provide equipment, goods and services that meet its customers' requirements. The Company's supplier relationships are often long-term due to the length of the product life-cycles and the relevant Directors meet with key suppliers and work with the BAE Systems Group's procurement function to develop deeper relationships with business in the supply chain and develop strategic relationships with key suppliers. In particular, during 2019, the Company hosted its first dedicated Tempest supplier event which was attended by more than 500 representatives that form the current and potential supplier base, providing information on the programme and how they could get involved.

The community and the environment

The Directors recognise the importance of leading a company that not only generates value for shareholders but also contributes to wider society. Through the Operational Framework the Company implements the requirements of the BAE Systems Group's Community Investment Policy, which looks to ensure that we build and nurture mutually beneficial relationships between our business, our people and local stakeholders. Giving back to the communities in which we operate, and to charities that have meaning to our business, is vitally important to our Company and our employees, allowing us to make a positive difference and have an impact where it counts. In particular, the Company is a major employer in Warton and Samlesbury, Lancashire (UK), and the Directors recognise the significance of the Company in the local community. The Company continued to work with Lancashire County Council and the Local Enterprise Partnership to develop the Samlesbury Enterprise Zone with the aim of creating an aerospace and technology hub. In Saudi Arabia, BAE Systems Group education ambassadors have offered their time to encourage school-age children to pursue STEM subjects and careers.

As a manufacturer, we recognise that our operations have an impact on the environment – from the energy and resources we use, to the products we manufacture and the waste that we generate. As an organisation, the BAE Systems Group is committed to reducing the environmental impact of our operations and products, minimising our environmental footprint and, in turn, decreasing our operational costs. Through the Operational Framework the Company implements the requirements of the BAE Systems Group's Environmental Policy, which details our commitment to high standards of environmental management.

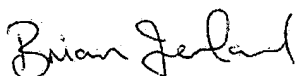
These activities form part of the Company's implementation of the BAE Systems Group-wide community and environment processes and policies and the BAE Systems Group's impacts thereon which are described in the "Environment and climate change" and "Fostering strong community partnerships" sections (pages 40 to 42) of BAE Systems plc's Annual Report 2019 (available at: www.baesystems.com/investors).

Maintaining a reputation for high standards of business conduct

The BAE Systems Group aims to be a recognised leader in business conduct which helps us to earn and maintain stakeholder trust and sustain business success. The Directors consider it fundamental to maintain a culture focused on embedding responsible business behaviours. All employees of the Company are expected to act in accordance with the requirements of BAE Systems Group policies, including the Code of Conduct, at all times. As well as being the right thing to do, this reduces the risk of compliance failure and supports us in attracting and retaining high-calibre employees.

Detailed information on the BAE Systems Group-wide business conduct processes and policies are described in BAE Systems plc's Annual Report 2019 (available at: www.baesystems.com/investors) and in particular the "Ethics and business conduct" section on pages 38-39.

Approved by the Board and signed on its behalf by:



B W Jerland
Director

24 June 2020

Directors' Report

Company registration

BAE Systems (Operations) Limited is a private company, limited by shares and registered in England and Wales with the registered number 01996687.

Results and dividends

The Company's profit for the financial year is £268m (2018 £420m).

The Directors do not propose a dividend for 2019 (2018 £154m).

Looking forward

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. 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 Company 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 Company's provision of capability to the Kingdom of Saudi Arabia and the Company will seek to work closely with the UK government to manage the impact of any such occurrence.

Since 31 December 2019, the Company has been affected by the COVID-19 pandemic (see Principal Risk entitled "The outbreak of contagious diseases may have a material adverse effect on the Company's business, financial condition and results of operations" on page 6). The future potential impact of the COVID-19 pandemic on the Company is not yet known but may be significant. While the Company cannot currently quantify what the effects might be, it continues to monitor the pandemic and its impact, to ensure appropriate actions can be taken to mitigate risks to the Company.

The terms of the UK's relationship with the EU after the end of the Transition Period are currently uncertain, rendering it difficult for the Company to prepare in detail for the changes in the regulatory environment that are likely to apply beyond the Transition Period.

Going concern

After making due enquiries, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for at least 12 months from the date of approval of the Financial Statements.

While there remains significant uncertainty as to the future impact of the COVID-19 pandemic, the Company and its ultimate parent entity BAE Systems plc continue to conduct ongoing risk assessments of the potential impact of the pandemic on its business operations and liquidity. The impact on the Company to date is set out in Note 26.

Having undertaken these assessments, the Directors consider that the Company will be able to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the Financial Statements.

Overseas offices

The Company has an overseas project office in India and a branch office in Qatar.

Employees

The Company is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Company. In the event of members of staff becoming disabled every effort is made to ensure that their employment with the Company continues and that appropriate training is arranged.

Employee engagement enables our employees to contribute to improving business performance and helps us to gauge our performance in creating an environment in which everyone can fulfil their potential. Engagement with UK employees has been considered on page 7 of the Strategic Report.

The Company welcomes employees becoming shareholders in BAE Systems plc, the Company's ultimate parent company, and BAE Systems plc offers employee share plans to support this.

Directors' Report *(continued)*

Research and development

The Company is focused on technology innovation and engineering excellence, investing in next-generation research and development programmes to deliver competitive solutions to meet our current and future customers' needs. Total research and development expenditure in the year was £379m (2018 £536m), of which £98m (2018 £44m) was funded by the Company.

Financial instruments

The international nature of the Company's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Company's policy is to hedge all material firm transactional exposures.

Qualifying Indemnity Provisions

The Directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited and BAE Systems Executive Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan and the BAE Systems Executive Pension Scheme, respectively, given by the Company, which are qualifying indemnity provisions for the purpose of the Companies Act 2006. All such indemnity provisions are in force at the date of this Directors' Report.

Engagement with suppliers, customers and others

Engagement with suppliers, customers and others has been considered on page 7 of the Strategic Report.

Corporate governance statement

BAE Systems plc, the ultimate parent company of the Company, adheres to the UK Corporate Governance Code. The UK Corporate Governance Code's principles are embedded in the BAE Systems Group Operational Framework, which sets out the principles of good governance and encapsulates the BAE Systems Group's values, policies and processes. Each company in the BAE Systems Group is required to adhere to the Operational Framework, which enables the Group to deliver operational excellence in a clear, accountable and consistent way.

The policies and processes in the Operational Framework are enacted at a local level by each of the businesses in the BAE Systems Group. The Operational Framework is underpinned by an Operational Assurance Statement which is a six-monthly process used to monitor compliance with the Operational Framework and policies.

Accordingly, the Company has not applied any separate corporate governance code for the financial year as it believes the corporate arrangements described in this statement are appropriate for the Company.

Set out below is a summary of how principles of good corporate governance, as set out in the Operational Framework, apply to the Company:

Purpose, strategy, values and culture

The BAE Systems Group has a strategic framework that sets out the Group's vision, mission and strategy and sets out three strategic priorities which are embedded throughout each business in the Group. This provides the link between the Group's long-term strategy and the near-term business objectives for all employees in the Company. The Company's businesses produce a strategic plan, a financial forecast for the current year and financial projections for the next five years, aligning resources with the delivery of forecast financial performance and the BAE Systems Group's strategic objectives. In so doing the Directors have regard to a variety of matters including the interests of various stakeholders, the consequences of their decisions in the long term and the long-term reputation of the Company and its businesses.

The BAE Systems Group's strategy is supported by the Group's values of trusted, innovative and bold. The Group has a Code of Conduct which lays out the standards that are expected of each employee in the Company, to support the employees in doing the right thing. All employees in the Company receive annual training designed to stimulate conversations about ethical decision making.

Board and Directors' accountability

The Directors of the Company are responsible for ensuring local policies, processes and charters are in place in the businesses of the Company to implement the requirements of the Operational Framework and for ensuring those requirements are met.

Directors' Report *(continued)*

Those requirements ensure that internal controls are in place that are designed to provide effective and measurable management of operational risk and performance, in line with BAE Systems Group requirements. These 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.

The requirements also regulate how the BAE Systems Group expects the employees of the businesses of the Company to be managed and the obligations placed on all employees concerning avoiding conflicts of interest, anti-bribery, and managing the security of employees, information and other assets.

As part of a robust system of internal controls, the authority of the Managing Director of the business of the Company is subject to financial limits and other restrictions, above which matters must be referred upwards and ultimately to the Board of BAE Systems plc.

Risk

Responsibility for identifying, analysing, evaluating and managing principal and emerging risks in the business lies with the Managing Directors of the businesses of the Company. They are also responsible for reporting and monitoring key risks in accordance with established processes under the BAE Systems Group's Operational Framework.

The BAE Systems 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. The Lifecycle Management Policy sets out how the Company must plan and manage the execution of projects above a certain minimum level, providing decision gate reviews at key stages from initial opportunity to final closure.

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.

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

Remuneration

The BAE Systems Group's Performance Leadership framework is a core business process designed to support the development of a diverse and inclusive culture that delivers the Group's strategy. The framework provides a principled approach to performance, assessment, development and reward for employees and is required to be implemented within the business of the Company.

Stakeholders

As regards employees, the Operational Framework includes a People Policy, pursuant to which the Directors and employees are required to contribute to creating an engaged and inclusive work environment, where individuals are respected and where the value of a diverse workforce is recognised. Pursuant to the policy, employees are also to be provided with the means to give their views and feedback, and for the feedback to be responded to appropriately.

As regards customers, the Operational Framework makes it a priority of each business to understand their customers' evolving needs and expectations, and deliver on their commitments throughout the life of the business's products and services. The Operational Framework requires businesses to measure the delivery of such customer focus through reviews with customers and measurement of schedule adherence.

As regards suppliers, the BAE Systems Group's policy is to identify and select suppliers which meet the Group's standards. The businesses manage risk with their suppliers in accordance with the BAE Systems Group's Procurement Policy, Lifecycle Management Framework and Supplier Principles. The Managing Directors of the businesses of the Company are required to oversee compliance with these policies and principles for the businesses for which they are responsible.

The BAE Systems Group's Environmental Policy outlines the Group's commitment to improving standards of environmental management, and compliance with the Policy is directed by environmental teams across the Group.

Directors' Report *(continued)*

Pursuant to the BAE Systems Group's Community Investment Policy, the Global Community Investment Strategy aims to build and nurture mutually beneficial relationships between the Group's businesses and local stakeholders, including employee involvement in charitable activities and donations to local, national and international charities.

Directors and their interests

The Directors who served throughout the year and up to the date of this Report, unless otherwise stated, were as follows:

Mr B W Ierland
Mr P J Lynas (resigned 31 March 2020)
Mr P R Earl (resigned 15 May 2020)
Mr C G Boardman
Ms A J Thompson (appointed 14 May 2020)
Mr T Fillingham (appointed 14 May 2020)
Mr M Taylor (appointed 14 May 2020)

The Board is not aware of any contract of significance in relation to the Company in which any Director has, or has had, a material interest.

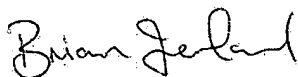
Disclosure of information to auditor

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 ought to have taken to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

Auditor

The auditor, Deloitte LLP, has indicated its willingness to continue in office and, in accordance with Section 487(2) of the Companies Act 2006, has been re-appointed.

Approved by the Board and signed on its behalf by:



B W Ierland
Director

24 June 2020

Registered office:
BAE Systems (Operations) Limited
Warwick House
PO Box 87
Farnborough Aerospace Centre
Farnborough
Hampshire
GU14 6YU
United Kingdom

Directors' Responsibilities Statement

The Directors are responsible for preparing the Directors' Report and the Financial Statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare Financial Statements for each financial year. Under that law the Directors have elected to prepare the Financial Statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), including Financial Reporting Standard 101 (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 Company and of the profit or loss of the Company for that period.

In preparing these Financial Statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the Financial Statements; and
- prepare the Financial Statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the Financial Statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Independent Auditor's Report to the Members of BAE Systems (Operations) Limited

Report on the audit of the Financial Statements

Opinion

In our opinion the Financial Statements of BAE Systems (Operations) Limited (the Company):

- give a true and fair view of the state of the Company's affairs as at 31 December 2019 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 101 Reduced Disclosure Framework; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the Financial Statements which comprise:

- the Income Statement;
- the Statement of Comprehensive Income;
- the Balance Sheet;
- the Statement of Changes in Equity; and
- the related notes 1 to 28.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards, including Financial Reporting Standard 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 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, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

We are required by ISAs (UK) to report in respect of the following matters where:

- the Directors' use of the going concern basis of accounting in preparation of the Financial Statements is not appropriate; or
- the Directors have not disclosed in the Financial Statements any identified material uncertainties that may cast significant doubt about the Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the Financial Statements are authorised for issue.

We have nothing to report in respect of these matters.

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.

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.

Independent Auditor's Report to the Members of BAE Systems (Operations) Limited (continued)

In preparing the Financial Statements, the Directors are responsible for assessing the 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 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.

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.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by 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 Company and its 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

Under the Companies Act 2006 we are required to report in respect of the following matters if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the Financial Statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in respect of these matters.

Use of our report

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an 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 Company and the 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

24 June 2020

Income Statement
for the year ended 31 December

	Notes	2019 £m	2018 £m
Revenue	2	5,584	5,012
Operating costs	3	(5,314)	(4,643)
Other income	4	46	65
Operating profit		316	434
Income from subsidiary undertakings and participating interests		-	4
Profit before finance costs and tax		316	438
Financial income	5	23	21
Financial expense	6	(64)	(54)
Profit before tax		275	405
Tax result	8	(7)	15
Profit for the year		268	420

Statement of Comprehensive Income
for the year ended 31 December

	Notes	2019 £m	2018 £m
Profit for the year		268	420
Other comprehensive income			
Items that will not be reclassified to the Income Statement:			
Remeasurements on post-employment benefit schemes	20	(488)	158
Tax on items that will not be reclassified to the Income Statement	8	76	(24)
Items that may be reclassified to the Income Statement:			
Currency translation on foreign currency branches	22	(1)	(1)
Amounts credited to hedging reserve	22	26	31
Tax on items that may be reclassified to the Income Statement	8	(3)	(6)
Total other comprehensive income for the year (net of tax)		(390)	158
Total comprehensive income for the year		(122)	578

The notes on pages 19 to 54 form part of the Financial Statements.

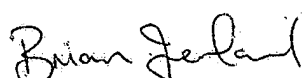
The results for 2019 and 2018 arise from continuing activities.

Balance Sheet
as at 31 December

	Notes	2019 £m	2018 ¹ £m
Non-current assets			
Intangible assets	9	150	187
Property, plant and equipment	10	409	409
Right-of-use assets	11	184	-
Investment property	12	44	3
Investments in subsidiary undertakings and participating interests	13	1	1
Other receivables	14	1,750	1,378
Post-employment benefit surpluses	20	49	50
Other financial assets	15	141	32
Deferred tax assets	16	382	323
		3,110	2,383
Current assets			
Inventories	18	269	285
Trade, other and contract receivables	14	7,301	7,609
Other financial assets	15	109	40
Current tax	17	129	51
Cash and cash equivalents		30	20
		7,838	8,005
Total assets		10,948	10,388
Non-current liabilities			
Lease liabilities	11	(246)	-
Other payables	19	(471)	(498)
Post-employment benefit obligations	20	(2,328)	(1,937)
Other financial liabilities	15	(122)	(16)
Provisions	21	(31)	(64)
		(3,198)	(2,515)
Current liabilities			
Lease liabilities	11	(17)	-
Trade and other payables	19	(5,899)	(5,809)
Other financial liabilities	15	(83)	(26)
Provisions	21	(83)	(112)
		(6,082)	(5,947)
Total liabilities		(9,280)	(8,462)
Net assets		1,668	1,926
Capital and reserves			
Issued share capital	22	1,008	1,008
Share premium		25	25
Other reserves	22	43	21
Retained earnings		592	872
Total equity		1,668	1,926

1. The Saudi Arabia end of service benefit obligation of £83m at 31 December 2018 has been reclassified from trade and other payables to post-employment benefit obligations (see note 20).

Approved by the Board on 24 June 2020 and signed on its behalf by:



B W Ireland
Director

Registered number: 01996687

Statement of Changes in Equity
for the year ended 31 December

	Notes	Issued share capital £m	Share premium £m	Other reserves ¹ £m	Retained earnings £m	Total equity £m
Balance at 31 December 2018		1,008	25	21	872	1,926
Adjustment upon adoption of IFRS 16 Leases		-	-	-	(1)	(1)
Balance at 1 January 2019		1,008	25	21	871	1,925
Profit for the year		-	-	-	268	268
Total other comprehensive income for the year		-	-	22	(412)	(390)
Total comprehensive income for the year		-	-	22	(144)	(122)
Share-based payments (inclusive of tax)	24	-	-	-	19	19
Ordinary share dividends	22	-	-	-	(154)	(154)
At 31 December 2019		1,008	25	43	592	1,668
Balance at 1 January 2018		1,008	25	(3)	566	1,596
Profit for the year		-	-	-	420	420
Total other comprehensive income for the year		-	-	24	134	158
Total comprehensive income for the year		-	-	24	554	578
Share-based payments (inclusive of tax)	24	-	-	-	18	18
Ordinary share dividends	22	-	-	-	(266)	(266)
At 31 December 2018		1,008	25	21	872	1,926

1. An analysis of other reserves is provided in note 22.

Notes to the Financial Statements

1 Accounting policies

BAE Systems (Operations) Limited (the Company) is a private company, limited by shares, and registered in England and Wales and incorporated in the United Kingdom. Its ultimate controlling party is BAE Systems plc. The address of the Company's registered office is shown on page 12. The principal activities of the Company are described in the Strategic Report on page 3.

These Financial Statements, which have been prepared in accordance with the Companies Act 2006, are presented in pounds sterling and, unless otherwise stated, rounded to the nearest million. Foreign operations are included in accordance with the policies set out in note 1.

Basis of preparation

These Financial Statements have been prepared in accordance with Financial Reporting Standard 101 (FRS 101) Reduced Disclosure Framework. The Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (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.

The Company is exempt under section 400 of the Companies Act 2006 from the requirement to prepare consolidated Financial Statements as it and its subsidiary undertakings are included by full consolidation in the consolidated Financial Statements of its ultimate parent, BAE Systems plc, a company registered in England and Wales. Accordingly, these Financial Statements present information about the Company as an individual undertaking and not as a Group.

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). These Financial Statements have been prepared using the going concern basis of accounting.

Notes to the Financial Statements (continued)

1 Accounting policies (continued)

Critical accounting policies

Certain of the Company'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 Financial Statements. The critical accounting policies are listed below:

Critical accounting policy	Description
Revenue and profit recognition	<p>The Company accounts for revenue in accordance with IFRS 15 Revenue from Contracts with Customers. For most of the Company's contracts, revenue and associated margin are recognised progressively over time as costs are incurred, and as risks have been mitigated or retired.</p> <p>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 Company'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.</p>
Deferred tax asset on post-employment benefit obligations	<p>The Company has recognised a deferred tax asset in respect of the deficits in its pension/post-employment schemes.</p> <p>It is management's judgement that the Company 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 Company's Integrated Business Plan.</p>
Tax provisions	<p>Provision is made for known issues based on management's interpretation of tax legislation and the likely outcome of negotiations or litigation. The Company'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.</p> <p>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 Company discloses any significant uncertainties in relation to tax matters to the relevant tax authority. The resolution of tax positions taken by the Company can take a considerable period of time to conclude and, in some cases, it is difficult to predict the outcome.</p>
Valuation of post-employment benefit obligations	<p>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.</p> <p>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 Company's circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit.</p>

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 Company'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 Company'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 Company'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 20 provides information on the key assumptions and analysis of their sensitivities.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

- 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 Company's inability to obtain or maintain the necessary export licenses. The long-term nature of many of the Company'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 2, the Company has recognised £0.2bn of revenue in both the current and prior financial year in respect of performance obligations satisfied or partially satisfied in previous periods. The Company 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.

Changes in accounting policies

IFRS 16 Leases became effective on 1 January 2019. The impact of adoption is set out in note 27.

Several other standards, interpretations and amendments to existing standards became effective on 1 January 2019, none of which had a material impact on the Company.

Significant accounting policies

The significant accounting policies applied in the preparation of these Financial Statements are set out below. These policies have been applied consistently to all the years presented, unless otherwise stated. The Directors believe that the Financial Statements reflect appropriate judgements and estimates, and provide a true and fair view of the Company's financial performance and position.

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 Company to customers in exchange for consideration in the ordinary course of the Company'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 Company 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 Company 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 Company'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 Company's pricing principles.

Whilst payment terms vary from contract to contract, on many of the Company's contracts, an element of the transaction price is received in advance of delivery. The Company therefore has significant contract liabilities. The Company'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.

Notes to the Financial Statements (continued)

1 Accounting policies (continued)

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 Company 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 Company's performance as it performs;
- the Company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the Company's performance does not create an asset with an alternative use to the Company and it has an enforceable right to payment for performance completed to date.

The Company 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 Company's performance as it performs (typically services or support contracts) or the Company's performance does not create an asset with an alternative use to the Company 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 Company 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 Company has determined that this method faithfully depicts the Company'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.

Contract modifications

The Company'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 Company'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; or
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 Company'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 Company expenses pre-contract bidding costs which are incurred regardless of whether a contract is awarded. The Company 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.

Notes to the Financial Statements (*continued*)

1 Accounting policies (*continued*)

Leases

The Company as lessee

All leases in which the Company 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 Company. 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 Company's incremental borrowing rate is used, which is the interest rate the Company 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 Company's right-of-use assets are reviewed at each Balance Sheet date to determine whether there is any indication of impairment.

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.

Comparative amounts for the year ended 31 December 2018 have not been restated on adoption of IFRS 16 Leases and are presented in accordance with IAS 17 Leases, whereby lease payments made under operating leases are recognised in the Income Statement on a straight-line basis over the lease term. See note 27 for further details.

The Company as lessor

Leases in which the Company 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.

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.

Research and development

The Company undertakes research and development activities either on its own behalf or on behalf of customers.

Company-funded expenditure on research and development activities not meeting the conditions for capitalisation is written off as incurred and charged to the Income Statement.

Where the research and development activity is performed on behalf of customers, the revenue arising is recognised in the Income Statement in accordance with the Company's revenue recognition policy.

Interest income and borrowing costs

Interest income and borrowing costs are recognised in the Income Statement in the period in which they are incurred.

Dividends

Dividends received and receivable are credited to the Company's Income Statement. Equity dividends paid on ordinary share capital are recognised as a liability in the period in which they are declared.

Intangible assets

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

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 businesses is included in intangible assets. Gains and losses on the disposal of a business include the carrying amount of goodwill relating to the business sold.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Software

Software includes:

- Computer software licences acquired for use within the Company which 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 Company, and that will probably generate economic benefits exceeding costs beyond one year, which are recognised as intangible assets. Company-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 Company 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.

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.

The estimated useful lives are as follows:

Software	- up to 5 years
Development costs	- up to 10 years

The Company has no indefinite-life intangible assets other than goodwill.

Property, plant and equipment

Cost

Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads. The cost of demonstration assets is written off as incurred.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and impairment losses.

Depreciation

Depreciation is provided, normally on a straight-line basis, to write off the cost of property, plant and equipment over their estimated useful lives to any estimated residual value, using the following rates:

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 or 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 Company's property, plant and equipment are reviewed at each Balance Sheet date to determine whether there is any indication of impairment.

Investment property

Cost

Land and buildings that are held to earn rentals or for capital appreciation are classified as investment property. The Company 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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Impairment

The carrying amounts of the Company's investment property are reviewed at each Balance Sheet date, to determine whether there is any indication of impairment.

Investments in subsidiary undertakings and participating interests

Investments in subsidiary undertakings and in participating interests are stated at cost less provision for impairment.

Impairment

The carrying amounts of the Company's assets are reviewed at each Balance Sheet date to determine whether there is any indication of impairment as required by IAS 36 Impairment of Assets. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet available for use, impairment testing is performed annually.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

The recoverable amount is the greater of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate. For an asset that does not generate largely independent cash flows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Impairment losses are recognised in the Income Statement.

An impairment loss in respect of other intangible assets, property, plant and equipment, investment property and right-of-use assets 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.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the Balance Sheet date. These exchange differences are recognised in the Income Statement.

The assets and liabilities of foreign currency branches are translated at the exchange rates ruling at the Balance Sheet date. The Income Statements of these branches are translated at average rates of exchange during the year. All resulting exchange differences are recognised in the translation reserve.

Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

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 Company 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, finance lease receivables and amounts owed by BAE Systems plc subsidiaries and joint ventures include a provision for expected credit losses. The Company measures the provision at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Company 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.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term deposits, and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value.

Trade and other payables

Trade and other payables are stated at amortised cost.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Tax

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 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.

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 Company's share of pension scheme deficits. 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 when contributions are paid to the pension schemes. In reviewing the probability that taxable profits will be available in the future against which such contributions can be deducted, account has been taken of the deficit recovery plans agreed with the trustees of the relevant schemes which run until 2026.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority and they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

Provisions

A provision is recognised in the Balance Sheet when the Company 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 Company 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 restructuring 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 Company 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.

Notes to the Financial Statements (continued)

1 Accounting policies (continued)

Post-employment benefits

Defined contribution pension schemes

A defined contribution pension scheme is a post-employment benefit plan under which the Company pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts.

Obligations for contributions are recognised as an expense in the Income Statement as incurred.

Defined benefit pension schemes

The cost of providing benefits is determined periodically by independent actuaries and charged to the Income Statement in the period in which those benefits are earned by the employees. Remeasurements, including actuarial gains and losses, are recognised in the 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 Company'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 43. The fair 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 Company 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.

The Company participates in a number of Group and multi-employer schemes administered by its ultimate parent company, BAE Systems plc. A share of the IAS 19 Employee Benefits pension deficit has been allocated to all participating employers. This allocation is based on the relative payroll contributions of active members, which is consistent with prior years. Whilst this methodology is intended to reflect a reasonable estimate of the share of the deficit, it may not accurately reflect the obligations of the participating employers. Gains and losses resulting from changes to the relative payroll contributions of active members year on year are included within actual return on assets and actuarial gains and losses for the disclosures in respect of changes in the fair value of scheme assets and changes in the present value of defined benefit obligations, respectively.

In the event that an employer who participates in BAE Systems plc'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 Company considers the likelihood of this event arising as remote.

Share-based payments

BAE Systems plc, the Company's ultimate parent company, issues equity-settled share-based payment awards to employees of the Company. In accordance with the requirements of IFRS 2 Share-based Payment, the Company has recognised a charge for these awards issued to its employees.

Equity-settled share options and Long-Term Incentive Plan arrangements are measured at fair value at the date of grant using an option pricing model.

The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of the number of shares that will actually vest.

Financial instruments

Derivative financial instruments and hedging activities

The international nature of the Company's business means that it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Company's policy is to hedge all material firm transactional exposures.

In accordance with its treasury policy, the Company does not hold derivative financial instruments for trading purposes.

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 Company has applied the IFRS 9 general hedge accounting requirements from the date of initial application on 1 January 2018.

Notes to the Financial Statements (continued)

1 Accounting policies (continued)

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 Company 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.

2 Revenue

Revenue by customer location

	2019 £m	2018 £m
United Kingdom	507	579
Rest of Europe	794	832
Middle East	3,350	2,703
USA and Canada	886	840
Asia and Pacific	39	48
Africa, and Central and South America	8	10
	5,584	5,012

Performance obligations

The Company's order book (representing the transaction price allocated to unsatisfied and partially unsatisfied performance obligations as defined by IFRS 15) as at 31 December 2019 was £16.3bn (2018 £18.8bn).

Revenue of £0.2bn (2018 £0.2bn) was recognised during the year ended 31 December 2019 in respect of performance obligations satisfied or partially satisfied in previous periods.

Notes to the Financial Statements (continued)

3 Operating costs

	2019 £m	2018 £m
Raw materials, subcontracts and other bought-in items used	3,593	2,684
Change in inventories of finished goods and work-in-progress	65	46
Staff costs (note 7)	1,029	1,171
Guaranteed Minimum Pension equalisation charge	-	57
Depreciation ¹	66	45
Amortisation	26	6
Derecognition of intangible assets (note 9)	36	-
Impairment of investment property (note 12)	7	-
Operating lease expense ²	-	26
Other operating charges	492	608
Operating costs	5,314	4,643

1. 2019 includes £13m of depreciation of right-of-use assets recognised under IFRS16 Leases, which became effective on 1 January 2019 (see note 11).

2. Operating lease expense is no longer applicable under IFRS16 Leases, which became effective on 1 January 2019. Amounts recognised in the Income Statement in respect of leases for 2019 are disclosed in note 11.

The remuneration of the auditor for the year ended 31 December 2019 for auditing of the Financial Statements was £0.9m (2018 £0.9m) in respect of audit work and £0.1m (2018 £0.1m) in respect of non-audit work.

Operating costs includes research and development expenditure of £98m (2018 £44m) funded by the Company.

4 Other income

	2019 £m	2018 £m
Research and development expenditure credits	12	21
Operating lease income from investment property	5	5
Other operating lease income	-	5
Management recharges	3	5
Saudi Arabia In-Kingdom Industrial Participation investment recovery	15	15
Other	11	14
Other income	46	65

5 Financial income

	2019 £m	2018 £m
Interest income on finance lease receivables (note 11)	1	-
Interest income in respect of loans to BAE Systems plc Group subsidiaries	22	21
Financial income	23	21

6 Financial expense

	2019 £m	2018 £m
Interest expense on lease liabilities (note 11)	7	-
Net interest expense on post-employment benefit obligations (note 20)	56	47
Net present value adjustments	1	7
Financial expense	64	54

Notes to the Financial Statements (continued)

7 Employees

The monthly average number of Company employees was as follows:

	2019 Number of employees	2018 Number of employees
Air	13,800	16,149
Electronic Systems	1,392	1,276
HQ	127	227
	15,319	17,652

The aggregate staff costs of Company employees were as follows:

	2019 £m	2018 £m
Wages and salaries	818	944
Social security costs	67	68
Pension costs – defined contribution plans (note 20)	10	16
Pension costs – defined benefit plans (note 20)	107	125
Other post-employment benefit costs (note 20)	8	-
Share-based payments (note 24)	19	18
	1,029	1,171

The disclosures below represent an allocation of the emoluments received by the Directors to reflect their qualifying services to the Company.

	2019 £'000	2018 £'000
Directors' remuneration	1,941	1,712
Amounts receivable under long-term incentive schemes	187	44
Company contributions to defined benefit pension schemes	501	455
	2,629	2,211

Post-employment benefits are accruing to the following number of Directors under:

	2019 Number of Directors	2018 Number of Directors
Defined benefit schemes	4	4

	2019 Number of Directors	2018 Number of Directors
Number of Directors who exercised share options	1	1
Number of Directors in respect of whose qualifying services shares were received or receivable under long-term incentive schemes	4	4

Amounts paid in respect of the highest paid Director were as follows:

	2019 £'000	2018 £'000
Remuneration and amounts receivable under long-term incentive schemes	889	806
Company contributions to defined benefit pension schemes	186	170

The highest paid Director's defined benefit accrued pension and accrued lump sum at 31 December 2019 was £213,603 (2018 £230,525) and £nil (2018 £nil), respectively.

During the year, the amount of money paid to or receivable by Directors under long-term incentive schemes in respect of qualifying services was £nil (2018 £nil).

Notes to the Financial Statements (continued)

8 Tax

Tax expense

	2019 £m	2018 £m
Current tax		
UK:		
Current tax	(19)	(39)
Adjustments in respect of prior years	(1)	15
	(20)	(24)
Overseas:		
Current tax expense	-	(1)
Adjustment in respect of prior years	15	30
	15	29
Total current tax	(5)	5
Deferred tax		
Origination and reversal of temporary differences	(3)	6
Adjustments in respect of prior years	1	4
Total deferred tax	(2)	10
Tax result	(7)	15

The deferred tax assets have been prepared applying a closing tax rate of 17% on the basis that any deferred assets or liabilities released or settled are likely to reverse after April 2020. However, in the Spring Budget 2020, the Government announced that from 1 April 2020 the corporation tax rate would remain at 19% (rather than reducing to 17%, as previously enacted). This new law was substantively enacted on 17 March 2020. As the proposal to keep the rate at 19% had not been substantively enacted at the Balance Sheet date, its effects are not included in these Financial Statements and the rate of 17% is used.

Total tax reconciliation

The following table reconciles the expected tax expense, using the UK corporation tax rate, to the reported tax expense.

	2019 £m	2018 £m
Profit before tax	275	405
UK corporation tax rate	19.00%	19.00%
Expected income tax expense	(52)	(77)
Expenses not tax effected	(5)	-
Income not subject to tax	13	16
Research and development expenditure credits and patent box benefits	1	6
Property, plant and equipment	(2)	-
Effect of tax rates in foreign jurisdictions	-	(1)
Provisions and accruals	1	-
Retirement benefit schemes	-	(1)
Share based payments	(1)	(1)
Imputed interest	20	(6)
Losses received from fellow group companies	3	30
Adjustments in respect of prior years	15	49
Tax result	(7)	15

Notes to the Financial Statements (continued)

8 Tax (continued)

Tax recognised in other comprehensive income

	2019			2018		
	Before tax £m	Tax expense £m	Net of tax £m	Before tax £m	Tax expense £m	Net of tax £m
Items that will not be reclassified to the Income Statement:						
Remeasurements on post-employment benefit schemes	(488)	76	(412)	158	(24)	134
Items that may be reclassified to the Income Statement:						
Currency translation on foreign currency branches	(1)	-	(1)	(1)	-	(1)
Amounts credited/(charged) to hedging reserve	26	(3)	23	31	(6)	25
	(463)	73	(390)	188	(30)	158

	2019			2018		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Post-employment benefit schemes	-	12	12	-	11	11
	-	12	12	-	11	11
Deferred tax						
Financial instruments	(3)	-	(3)	(6)	-	(6)
Post-employment benefit schemes	-	64	64	-	(35)	(35)
	(3)	64	61	(6)	(35)	(41)
Tax on other comprehensive income	(3)	76	73	(6)	(24)	(30)

Notes to the Financial Statements (*continued*)

9 Intangible assets

	Goodwill £m	Software £m	Development costs £m	Other £m	Total £m
Cost					
At 1 January 2019	29	194	15	-	238
Additions:					
Internally developed	-	8	-	-	8
Acquired separately	-	17	-	4	21
Derecognition ¹	-	(36)	-	-	(36)
Transfer from property, plant and equipment	-	2	-	-	2
Transfer to BAE Systems plc	-	(6)	-	-	(6)
At 31 December 2019	29	179	15	4	227
Amortisation and impairment					
At 1 January 2019	-	41	10	-	51
Amortisation charge	-	20	2	4	26
Transfer from property, plant and equipment	-	2	-	-	2
Transfer to BAE Systems plc	-	(2)	-	-	(2)
At 31 December 2019	-	61	12	4	77
Net book value					
At 31 December 2019	29	118	3	-	150
At 31 December 2018	29	153	5	-	187

1. The derecognition of software intangible assets relates to an Enterprise Resource Planning transformation programme which went live during the year. The charge in respect of this derecognition is presented within operating costs (note 3).

Impairment testing

The recoverable amount of the Company's goodwill is based on value-in-use estimated using risk-adjusted future cash flow projections from the five-year Integrated Business Plan and a terminal value based on the projections for the final year of that plan, with a growth rate assumption of 2% applied. The Integrated Business Plan process includes the use of historical experience, available government spending data and the Company's order backlog. A pre-tax discount rate, derived from the Company's post-tax weighted average cost of capital of 6.62% (2018 7.24%) (adjusted for risks specific to the market in which the cash-generating unit operates), has been used in discounting these projected risk-adjusted cash flows.

Software

The software intangible assets balance includes £85m (2018 £135m) relating to an Enterprise Resource Planning transformation programme which went live during the year. The remaining amortisation period is four years.

Capital commitments

At 31 December 2019, capital expenditure of £1m (2018 £6m) in respect of intangible assets was contracted but not provided for in the Financial Statements.

Notes to the Financial Statements (continued)

10 Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Total £m
Cost or valuation			
At 1 January 2019	193	841	1,034
Additions	8	41	49
Transfer to other intangible assets	-	(2)	(2)
Disposals	-	(1)	(1)
At 31 December 2019	201	879	1,080
Depreciation and impairment			
At 1 January 2019	123	502	625
Depreciation charge for the year	5	44	49
Transfer to other intangible assets	-	(2)	(2)
Disposals	-	(1)	(1)
At 31 December 2019	128	543	671
Net book value			
At 31 December 2019	73	336	409
At 31 December 2018	70	339	409
Non-depreciated assets (included above):			
Assets in the course of construction			
At 31 December 2019	7	84	91
At 31 December 2018	-	62	62

Capital commitments

At 31 December 2019, capital expenditure of £42m (2018 £28m) in respect of property, plant and equipment was contracted but not provided for in the Financial Statements.

11 Leases

IFRS 16 Leases became effective on 1 January 2019. The impact of adoption is set out in note 27.

The Company 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.

Right-of-use assets

	31 December 2019		
	Land and buildings £m	Plant and machinery £m	Total £m
Additions during the year	1	1	2
Depreciation expense for the year	12	1	13
Net book value	182	2	184

Notes to the Financial Statements (continued)

11 Leases (continued)

Lease liabilities

A maturity analysis of the future undiscounted lease payments in respect of the Company's lease liabilities is presented in the table below.

	2019 £m
Payments due:	
Within one year	24
Between one and five years	89
Later than five years	212
	325

The total cash outflow for leases in the year ended 31 December 2019, including short-term leases and low-value leases, amounted to £25m.

Amounts recognised in the Income Statement

	2019 £m
Included in operating costs:	
Depreciation on right-of-use assets	(13)
Short-term lease expense	(3)
	(16)
Included in other income:	
Operating lease income from investment property	5
	5
Included in net finance costs:	
Interest income on finance lease receivables	1
Interest expense on lease liabilities	(7)
	(6)

Finance lease receivables

From 1 January 2019, certain of the Company's subleases where the Company 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 Company 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 Company is lessor is presented in the table below.

	Notes	2019 £m
Receipts due:		
Within one year		4
Between one and two years		4
Between two and three years		4
Between three and four years		4
Between four and five years		4
Later than five years		16
Total undiscounted gross receipts		36
Deduct: Impact of discounting		(4)
Finance lease receivables	14	32

Notes to the Financial Statements (continued)

12 Investment property

	£m
Cost	
At 31 December 2018	3
Cost recognised on transition to IFRS 16	49
Additions	5
At 31 December 2019	57
Depreciation and impairment	
At 31 December 2018	-
Impairment recognised on transition to IFRS 16	2
Depreciation charge for the year	4
Impairment charge for the year	7
At 31 December 2019	13
Net book value	
At 31 December 2019	44
At 31 December 2018	3
Fair value	
At 31 December 2019	55
At 31 December 2018	6

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.

13 Investments in subsidiary undertakings and participating interests

	£m
Net book value	
At 1 January and 31 December 2019	1

Subsidiary undertakings and participating interests at 31 December 2019

In accordance with Section 409 of the Companies Act 2006, a full list of subsidiary undertakings and significant holdings as at 31 December 2019 is disclosed below. Unless otherwise stated, all subsidiary undertakings and significant holdings are owned directly by the Company and have a financial year end of 31 December.

Company name	Class of shares held	Proportion of class (%)
BAE Systems (Aviation Services) Limited Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire, GU14 6YU, United Kingdom	Ordinary shares of £1	50
BAE Systems (Kazakhstan) Limited Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire, GU14 6YU, United Kingdom	Ordinary shares of £1	100
BAE Systems Deployed Systems Limited Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire, GU14 6YU, United Kingdom	Ordinary shares of £1	60

Notes to the Financial Statements *(continued)*

14 Trade, other and contract receivables

	2019 £m	2018 £m
Non-current		
Contract receivables	26	-
Amounts owed by BAE Systems plc and its subsidiaries	1,638	1,372
Prepayments and accrued income	56	-
Finance lease receivables (note 11)	28	-
Other receivables	2	6
	1,750	1,378
Current		
Contract receivables	717	530
Trade receivables	709	607
Amounts owed by BAE Systems plc and its subsidiaries	4,819	5,295
Amounts owed by BAE Systems Group joint ventures (note 23)	43	39
Prepayments and accrued income	734	932
Finance lease receivables (note 11)	4	-
Other receivables	275	206
	7,301	7,609

Receivables are stated net of any provision for expected credit losses.

Contract receivables as at 1 January 2018 were £227m.

15 Other financial assets and liabilities

	2019		2018	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	141	(122)	32	(16)
Current				
Cash flow hedges – foreign exchange contracts	109	(83)	40	(26)

Notes to the Financial Statements (continued)

16 Deferred tax

Deferred tax assets

	Deferred tax assets		Deferred tax liabilities		Net deferred tax balances	
	2019	2018	2019	2018	2019	2018
	£m	£m	£m	£m	£m	£m
Property, plant and equipment	18	12	-	-	18	12
Provisions and accruals	12	22	-	-	12	22
Post-employment benefit schemes	359	293	-	-	359	293
Share-based payments	1	1	-	-	1	1
Financial instruments	-	-	(8)	(5)	(8)	(5)
Deferred tax assets/liabilities	390	328	(8)	(5)	382	323
Set off of assets/liabilities	(8)	(5)	8	5	-	-
Net deferred tax assets	382	323	-	-	382	323

Movement in temporary differences during the year

	At 1 January 2019 £m	Recognised in income £m	Recognised in equity £m	At 31 December 2019 £m
Property, plant and equipment	12	6	-	18
Provisions and accruals	22	(10)	-	12
Post-employment benefit schemes	293	2	64	359
Share-based payments	1	-	-	1
Financial instruments	(5)	-	(3)	(8)
	323	(2)	61	382

	At 1 January 2018 £m	Recognised in income £m	Recognised in equity £m	At 31 December 2018 £m
Property, plant and equipment	12	-	-	12
Provisions and accruals	29	(7)	-	22
Post-employment benefit schemes	314	14	(35)	293
Share-based payments	2	(1)	-	1
Financial instruments	1	-	(6)	(5)
Other temporary differences	(4)	4	-	-
	354	10	(41)	323

The deferred tax assets have been prepared applying a closing tax rate of 17% on the basis that any deferred tax assets or liabilities released or settled are likely to reverse after April 2020. However, in the Spring Budget 2020, the Government announced that from 1 April 2020 the corporation tax rate would remain at 19% (rather than reducing to 17%, as previously enacted). This new law was substantively enacted on 17 March 2020. As the proposal to keep the rate at 19% had not been substantively enacted at the Balance Sheet date, its effects are not included in these Financial Statements and the rate of 17% is used. If the proposal had been substantively enacted at the Balance Sheet date the deferred tax assets would have increased to £427m due to the change in the tax rate.

Notes to the Financial Statements *(continued)*

17 Current tax

	2019 £m	2018 £m
Tax provisions	(50)	(59)
Research and development expenditure credits receivable	182	160
Other	(3)	(50)
	129	51
Represented by:		
Current tax assets	129	51
Current tax liabilities	-	-
	129	51

18 Inventories

	2019 £m	2018 £m
Work-in-progress	86	131
Raw materials and consumables	165	135
Finished goods and goods for resale	18	19
	269	285

The Company recognised £nil as a write down of inventories to net realisable value (2018 £nil).

19 Trade and other payables

	2019 £m	2018 ¹ £m
Non-current		
Contract liabilities	459	483
Accruals and deferred income	12	13
Other payables	-	2
	471	498
Current		
Contract liabilities	2,482	2,535
Trade payables	137	149
Amounts owed to BAE Systems plc and its subsidiaries	2,162	2,213
Amounts owed to BAE Systems Group joint ventures (note 23)	120	86
Other taxes and social security costs	50	52
Accruals and deferred income	881	729
Other payables	67	45
	5,899	5,809

1. The Saudi Arabia end of service benefit obligation of £83m at 31 December 2018 has been reclassified from trade and other payables to post-employment benefit obligations (see note 20).

Revenue recognised in the year includes £2,277m (2018 £1,545m) that was included in the opening contract liabilities balance.

Non-current and current contract liabilities as at 1 January 2018 were £761m and £1,856m, respectively.

Notes to the Financial Statements *(continued)*

20 Post-employment benefits

Background

BAE Systems plc operates pension schemes for qualifying employees in the UK, US and other countries. The principal schemes in the UK 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 allocation of each Company's share of the pension deficit is based on the relative payroll contributions of active members, as outlined on page 27. This is now being calculated on the basis of contributions into the newly merged Main Scheme rather than for each legacy scheme separately. As each of the legacy schemes had different funding levels compared to the merged Main Scheme, there are resulting gains and losses. These gains and losses are recorded within other comprehensive income in the Statement of Comprehensive Income and are included within actual return on assets and actuarial gains and losses for the disclosures in respect of changes in the fair value of scheme assets and changes in the present value of defined benefit obligations, respectively.

As a result of merging the schemes detailed above, the Company now participates in the BAE Systems Pension Scheme (Main Scheme), the BAE Systems Executive Pension Scheme and the Royal Ordnance Pension Scheme.

At 31 December 2019, the weighted average durations of the UK defined benefit pension obligations were 17 years (2018 17 years).

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the most significant schemes (based on the size of the closing net deficit/surplus) is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme (merged) ¹	31	21	48
Royal Ordnance Pension Scheme ²	18	20	62

1. Source: 31 October 2019 actuarial valuation reports for the legacy schemes within the recently-merged Main Scheme.

2. Source: Royal Ordnance Pension Scheme actuarial valuation as at 31 March 2017.

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 BAE Systems plc.

Benefits

The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The Normal Retirement Age for active members of the Main Scheme is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: www.baesystemspensions.com.

A UK High Court judgment 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 was included within the pension deficit which 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.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

Other post-employment benefits

The Company 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 Company considers this to be a more appropriate presentation. The comparative balance sheet has also 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 provided below reflect the pension schemes as a whole. Disclosures in respect of pension accounting under IAS19 are provided on pages 44 to 48.

The majority of the UK defined benefit pension schemes are funded by BAE Systems plc'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 professional qualified independent actuaries and include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 44. 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.

Valuations

Funding valuations of the UK defined benefit schemes are performed every three years. Following the merger of several of the UK pension schemes in October 2019, BAE Systems plc and the 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

Notes to the Financial Statements *(continued)*

20 Post-employment benefits *(continued)*

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 are 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 BAE Systems plc 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, BAE Systems plc 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.

Contributions

Under the terms of the trust deeds of the UK schemes, BAE Systems plc is required to have a funding plan determined at the conclusion of the triennial funding valuations.

The total Company contributions made to the defined benefit schemes in the year ended 31 December 2019 were £255m (2018 £255m) in line with the schedule of contributions.

Deficit contributions will further increase in line with any percentage growth in dividend payments made by BAE Systems plc. As part of the 31 October 2019 valuation agreement, BAE Systems plc agreed to pay £1bn into the Main Scheme in 2020 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.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

Risk management

The defined benefit pension schemes expose the Company 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.	<p>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.</p> <p>Some 49% (2018 47%) of the UK pension scheme assets are held in equities and pooled investment vehicles due to the higher expected level of return over the long term.</p> <p>Some of the 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.</p>
Interest rate risk Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	<p>In addition to investing in bonds as part of the matching portfolio, the UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk.</p> <p>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 Company expects the schemes to be fully hedged against interest rate movements following a five-year transition period to the planned investment strategy.</p>
Inflation risk Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	<p>In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk.</p> <p>The UK funding valuations provide a natural hedge against inflation movements within the discount rate. The Company is already fully hedged against inflation movements and, under the planned investment strategy, aims to maintain a fully hedged position.</p> <p>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.</p>
Longevity risk Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	<p>Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees.</p> <p>In 2013, with the agreement of BAE Systems plc, the trustees of the 2000 Plan, Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme (SIPS) 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.</p>

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

IAS 19 Accounting

Principal actuarial assumptions

The disclosures below relate to pension schemes in the UK which are accounted for as defined benefit schemes in accordance with IAS 19.

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.

	2019	2018	2017
Financial assumptions			
Discount rate – past service (%)	2.1	2.9	2.6
Discount rate – future service (%)	2.2	3.0	2.7
Retail Prices Index (RPI) Inflation (%)	2.8	3.1	3.1
Rate of increase in salaries (%)	2.8	3.1	3.1
Rate of increase in deferred pensions (%)	2.0/2.8	2.1/3.1	2.1/3.1
Rate of increase in pensions in payment (%)	1.5 – 3.6	1.6 – 3.7	1.6 – 3.7
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	87 – 88	86 – 88	86 – 88
Life expectancy of a female currently aged 65 (years)	88 – 90	88 – 90	88 – 90
Life expectancy of a male currently aged 45 (years)	88 – 89	88 – 90	88 – 90
Life expectancy of a female currently aged 45 (years)	89 – 91	90 – 91	90 – 92

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments of the principal schemes using a third-party AA corporate bond yield curve to produce a single equivalent discount rate. This inherently captures the maturity profile of the expected benefit payments. 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 40.

Retail Prices Index (RPI) Inflation

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%.

Rate of increase in salaries

The rate of increase in salaries is assumed to be RPI inflation of 2.8% (2018 3.1%), plus a promotional scale.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on Consumer Prices Index (CPI) inflation of 2.0% (2018 CPI inflation of 2.1%), with the exception of the 2000 Plan, which is based on RPI inflation of 2.8% (2018 RPI inflation of 3.1%). The rate of increase in deferred pensions is subject to inflation caps.

Rate of increase in pensions in payment

The rate of increase in pensions in payment differs between UK schemes. Different tranches of the schemes increase at rates based on either RPI or CPI inflation, and some are subject to an inflation cap. With the exception of two smaller schemes, the rate of increase in pensions in payment is based on RPI inflation.

Life expectancy

The Company 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 ('Sk') of 7 for all members.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

The disclosures below are in respect of the Company's share of the IAS 19 deficit using the allocation methodology outlined on page 27.

Summary of movements in post-employment benefit obligations

	Pension £m	Other £m	Total £m
Company's share of IAS 19 deficit at 1 January 2019 ¹	(1,804)	(83)	(1,887)
Transfer to other Group companies	-	25	25
Actual return on assets excluding amounts included in interest expense	1,866	-	1,866
Increase in liabilities due to changes in assumptions and experience	(2,336)	(18)	(2,354)
Contributions in excess of service cost	104	26	130
Past service cost – plan amendments	(4)	-	(4)
Net interest expense	(52)	(4)	(56)
Foreign exchange adjustments	-	1	1
Company's share of IAS 19 deficit at 31 December 2019	(2,226)	(53)	(2,279)

Amounts recognised on the Balance Sheet

	2019			2018		
	UK defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m	UK defined benefit pension schemes £m	Saudi Arabia end of service benefit ¹ £m	Total £m
Present value of unfunded obligations	(19)	(53)	(72)	(21)	(83)	(104)
Present value of funded obligations	(13,874)	-	(13,874)	(11,582)	-	(11,582)
Fair value of scheme assets	11,667	-	11,667	9,799	-	9,799
Company's share of IAS 19 deficit, net	(2,226)	(53)	(2,279)	(1,804)	(83)	(1,887)
Represented by:						
Post-employment benefit surpluses	49	-	49	50	-	50
Post-employment benefit obligations	(2,275)	(53)	(2,328)	(1,854)	(83)	(1,937)
	(2,226)	(53)	(2,279)	(1,804)	(83)	(1,887)

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 Company considers this to be a more appropriate presentation.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

Changes in the fair value of scheme assets

	Defined benefit pension schemes £m	Saudi Arabia end of service benefit ¹ £m	Total £m
Company's share of the value of scheme assets at 1 January 2018	10,194	-	10,194
Interest income	261	-	261
Actual return on assets excluding amounts included in interest income	(427)	-	(427)
Actual return on assets	(166)	-	(166)
Contributions by employer	213	83	296
Contributions by employer in respect of employee salary sacrifice arrangements	42	-	42
Total contributions by employer	255	83	338
Members' contributions	4	-	4
Administrative expenses	(6)	-	(6)
Benefits paid	(482)	(83)	(565)
Company's share of the value of scheme assets at 31 December 2018	9,799	-	9,799
Interest income	310	-	310
Actual return on assets excluding amounts included in interest income	1,866	-	1,866
Actual return on assets	2,176	-	2,176
Contributions by employer	214	34	248
Contributions by employer in respect of employee salary sacrifice arrangements	41	-	41
Total contributions by employer	255	34	289
Members' contributions	4	-	4
Administrative expenses	(7)	-	(7)
Benefits paid	(560)	(34)	(594)
Company's share of the value of scheme assets at 31 December 2019	11,667	-	11,667

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 Company considers this to be a more appropriate presentation.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

Assets of defined benefit pension schemes

	2019			2018		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	1,199	1	1,200	1,543	1	1,544
Overseas	1,047	1	1,048	980	7	987
Pooled investment vehicles ¹	1,047	2,780	3,827	146	1,951	2,097
Fixed interest securities:						
UK gilts	396	-	396	524	-	524
UK corporates	580	1,282	1,862	622	1,010	1,632
Overseas government	22	-	22	24	-	24
Overseas corporates	744	8	752	618	17	635
Index-linked securities:						
UK gilts	889	162	1,051	884	2	886
UK corporates	138	540	678	307	245	552
Property ²	-	945	945	-	960	960
Derivatives ³	-	(529)	(529)	-	(265)	(265)
Cash:						
Sterling	331	4	335	133	6	139
Foreign currency	17	1	18	5	1	6
Other	7	55	62	17	61	78
Company total	6,417	5,250	11,667	5,803	3,996	9,799

1. 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.

2. 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.

3. Includes equity protection options, forward foreign exchange contracts, futures, and interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.

Notes to the Financial Statements (continued)

20 Post-employment benefits (continued)

Changes in the present value of the defined benefit obligations

	Defined benefit pension schemes £m	Saudi Arabia end of service benefit ¹ £m	Total £m
Company's share of the defined benefit obligations at 1 January 2018	(12,133)	(138)	(12,271)
Current service cost	(116)	(17)	(133)
Contributions by employer in respect of employee salary sacrifice arrangements	(43)	-	(43)
Total current service cost	(159)	(17)	(176)
Members' contributions	(4)	-	(4)
Past service cost – plan amendments	(66)	-	(66)
Actuarial gain due to changes in assumptions and experience	585	-	585
Interest expense	(308)	(7)	(315)
Benefits paid	482	83	565
Foreign exchange translation	-	(4)	(4)
Company's share of the defined benefit obligations at 31 December 2018	(11,603)	(83)	(11,686)
Transfer to other Group companies	-	25	25
Current service cost	(103)	(8)	(111)
Contributions by employer in respect of employee salary sacrifice arrangements	(41)	-	(41)
Total current service cost	(144)	(8)	(152)
Members' contributions	(4)	-	(4)
Past service cost – plan amendments	(4)	-	(4)
Actuarial loss due to changes in assumptions and experience	(2,336)	(18)	(2,354)
Interest expense	(362)	(4)	(366)
Benefits paid	560	34	594
Foreign exchange translation	-	1	1
Company's share of the defined benefit obligations at 31 December 2019	(13,893)	(53)	(13,946)

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 Company considers this to be a more appropriate presentation.

Amounts recognised in the Income Statement

	2019			2018		
	UK defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m	UK defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m
Included in operating costs:						
Current service cost	(103)	(8)	(111)	(116)	-	(116)
Past service cost – plan amendments	(4)	-	(4)	(9)	-	(9)
	(107)	(8)	(115)	(125)	-	(125)
Guaranteed Minimum Pension equalisation charge	-	-	-	(57)	-	(57)
Administrative expenses	(7)	-	(7)	(6)	-	(6)
	(114)	(8)	(122)	(188)	-	(188)
Included in finance costs:						
Net interest expense on post-employment benefit obligations	(52)	(4)	(56)	(47)	-	(47)

The Company incurred a charge of £10m (2018 £16m) in relation to defined contribution schemes for employees.

Notes to the Financial Statements (continued)

20 Post-employment benefits (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 44.

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 after allocation to other participating employers, is shown in the table below. The estimated impact on scheme assets takes into account the 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 £bn	Increase/ (decrease) in scheme assets £bn
Discount rate:		
0.1 percentage point increase	0.2	(0.1)
0.1 percentage point decrease	(0.2)	0.1
Inflation:		
0.1 percentage point increase	(0.2)	0.1
0.1 percentage point decrease	0.2	(0.1)

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions (rate of increase in salaries, rate of increase in deferred pensions and rate of increase in pensions in payment) used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/ decrease in pension obligation £bn
Inflation:	
0.5 percentage point increase	(0.8)
0.5 percentage point decrease	0.8
1.0 percentage point increase	(1.6)
1.0 percentage point decrease	1.5

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements, would have the following effect on the net IAS 19 deficit:

	(Increase)/ decrease in net deficit £bn
Life expectancy:	
One-year increase	(0.6)
One-year decrease	0.6

Notes to the Financial Statements *(continued)*

21 Provisions

	Warranties and after-sales service	Reorganisations	Legal, contractual and environmental	Other	Total
	£m	£m	£m	£m	£m
Non-current	8	50	6	-	64
Current	17	20	62	13	112
At 31 December 2018	25	70	68	13	176
Transition adjustment upon adoption of IFRS 16 Leases	-	-	(1)	-	(1)
Created	10	-	16	2	28
Released	(3)	(29)	(23)	(6)	(61)
Utilised	(7)	(17)	(3)	(2)	(29)
Transfer from inventories	-	-	1	-	1
At 31 December 2019	25	24	58	7	114
Represented by:					
Non-current	11	18	2	-	31
Current	14	6	56	7	83
	25	24	58	7	114

Warranties and after-sales service

Warranty and after-sales service costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum, but not the timing, of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations

Reorganisation costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

Other debtors includes £18m (2018 £30m) 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 uncertain, the Company expects the majority of these provisions to be utilised over a period of approximately one year.

Other

There are no individually significant provisions within other provisions.

Notes to the Financial Statements (*continued*)

22 Share capital and other reserves

Share capital

	£1 'A' Ordinary shares '000	£1 'B' Ordinary shares '000	Nominal value £m
Issued and fully paid			
At 1 January 2018, 31 December 2018 and 31 December 2019	1,007,340	180	1,008

The 'A' and 'B' Ordinary shares rank pari passu in all respects.

Prior year 15.3p dividend per 'A' and 'B' Ordinary share paid in the year was £154m.

Other reserves

	Hedging reserve £m	Translation reserve £m	Total £m
At 1 January 2018	(5)	2	(3)
Amounts credited to hedging reserve	31	-	31
Currency translation on foreign currency branches	-	(1)	(1)
Tax on amounts credited to hedging reserve	(6)	-	(6)
At 31 December 2018	20	1	21
Amounts credited to hedging reserve	26	-	26
Currency translation on foreign currency branches	-	(1)	(1)
Tax on amounts credited to hedging reserve	(3)	-	(3)
At 31 December 2019	43	-	43

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 results and financial position of foreign currency branches.

Notes to the Financial Statements (continued)

23 Related party transactions

The Company has a related party relationship with non wholly-owned BAE Systems Group subsidiaries, BAE Systems Group joint ventures and BAE Systems Group pension schemes. Transactions occur with related parties in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The significant transactions are disclosed below:

Related party	Amounts owed to related party		Amounts owed by related party		Sales to related party		Purchases from related party ¹	
	2019 £m	2018 £m	2019 £m	2018 £m	2019 £m	2018 £m	2019 £m	2018 £m
Aircraft Accessories and Components Company Limited	-	-	-	-	-	-	-	2
International Systems Engineering Company Limited	7	4	-	-	-	-	23	15
Prismatic Limited	1	-	-	-	-	-	3	-
BAE Systems Saudi Development and Training Company Limited	51	32	-	-	-	-	448	128
Saudi Maintenance & Supply Chain Management Company Limited	133	319	-	-	1	-	387	340
Non wholly-owned BAE Systems Group subsidiaries	192	355	-	-	1	-	861	485
Advanced Electronics Company Limited	8	24	-	-	-	-	215	166
BAE Systems Strategic Aerospace Services WLL	3	-	-	-	-	-	-	-
Eurofighter Jagdflugzeug GmbH	21	22	41	37	854	1,028	248	313
MBDA SAS	88	40	-	-	1	1	164	199
Panavia Aircraft GmbH	-	-	1	2	27	32	16	26
Reaction Engines Limited	-	-	-	-	-	1	-	-
Sealand Support Services Limited	-	-	1	-	2	1	-	-
BAE Systems Group joint ventures	120	86	43	39	884	1,063	643	704
BAE Systems Pension Funds Trustees Limited ²	170	-	-	-	-	-	15	13
BAE Systems Group pension schemes	170	-	-	-	-	-	15	13

1. 2018 purchases from related parties have been restated to include £313m of purchases from Eurofighter Jagdflugzeug GmbH.

2. Transactions with BAE Systems Pension Funds Trustees Limited represent lease arrangements for land and buildings leased by BAE Systems (Operations) Limited. Amounts owed at 31 December 2019 include £170m in respect of lease liabilities measured under IFRS 16. The undiscounted minimum lease commitments to this related party at 31 December 2018 were £229m, which is not included within amounts owed to related parties in the table above.

24 Share-based payments

Share-based payment awards in respect of shares in the ultimate parent company, BAE Systems plc, have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Annual Remuneration Report of the BAE Systems plc Annual Report 2019.

For options outstanding at the end of the year:

	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	3.89 - 6.49	8	3.89 - 6.49	8
Performance Share Plan	-	5	-	5

The average share price in the year was £5.21 (2018 £5.89).

Notes to the Financial Statements (*continued*)

25 Contingent liabilities

The Company has no individually significant contingent liabilities.

26 Events after the reporting period

The outbreak of the COVID-19 coronavirus was confirmed to be a global pandemic by the World Health Organisation on 11 March 2020 and only after that date did major governments, such as the UK, start taking significant mitigating steps. As such the Company considers this to be a non-adjusting post Balance Sheet event. The full impact of the COVID-19 pandemic on medium- and long-term economic activity is not yet known, although is likely to be significant. The Company continues to monitor the impact on its business, however while the uncertainty continues, the Company is not able to quantify the possible financial effect of the pandemic. Some asset and liability carrying values may be impacted, particularly where they are reliant on management's use of estimates and judgements when applying accounting policies. Potential areas of the Company's Financial Statements which could be materially impacted may include, but are not limited to:

- Recognition of revenue and associated margin recognised as costs are incurred and as risks are mitigated or retired;
- The valuation of post-post-employment benefit obligations and related deferred tax balances, if estimates relating to actuarial assumptions (including discount and inflation rate assumptions) are no longer valid or change significantly, or if scheme asset values are affected by the impact of the pandemic;
- The carrying value of property, plant and equipment, right-of-use assets, investment property and investments in other Group companies;
- Potential credit losses on receivables; the valuation of other financial assets and liabilities; and
- Amendments to existing provisions, or new provisions, being required as a consequence of the pandemic.

27 Adoption of IFRS 16 Leases

IFRS 16 Leases became effective on 1 January 2019 and replaced IAS 17 Leases, and related interpretations. It results 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 have been recognised. The only exceptions are short-term leases, low-value leases and leases of intangible assets.

The Company has applied the modified retrospective transition approach and has not restated comparative amounts for the year ended 31 December 2018. The Company 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).

The Company 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.

Notes to the Financial Statements *(continued)*

27 Adoption of IFRS 16 Leases *(continued)*

Accounting policy

The accounting policy in respect of leases applied from 1 January 2019 is set out in note 1. Comparative amounts for the year ended 31 December 2018 have not been restated and are presented in accordance with IAS 17 Leases, whereby lease payments made under operating leases are recognised in the Income Statement on a straight-line basis over the lease term.

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	342
Impact of discounting lease liability under IFRS 16	(67)
Lease liability recognised on transition to IFRS 16 at 1 January 2019	(275)

The weighted average incremental borrowing rate applied to lease liabilities was 2.73%.

28 Controlling party

The Company is a subsidiary undertaking of BAE Systems Enterprises Limited and the ultimate controlling party is BAE Systems plc, which is both the smallest and largest parent company preparing Group Financial Statements. Both companies are incorporated in the United Kingdom and registered in England and Wales.

The consolidated Financial Statements of BAE Systems plc are available to the public and may be obtained from its registered address:

6 Carlton Gardens
London
SW1Y 5AD

Website: www.baesystems.com