BAE Systems (Operations) Limited

Annual Report and Financial Statements

31 December 2021

Registered Number: 01996687

Contents

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, Saudi Arabian businesses and development of Future Combat Air Systems), the Group's Electronic Systems business based in Rochester, UK, and elements of the Group's UK Shared Services business.

Review of business

European and International Markets
Activity on the 24 Typhoon and nine Hawk aircraft and associated support and training contract for the State of Qatar is progressing well. In 2021, the first five Hawk aircraft were accepted by the customer and entered into service at RAF Leeming, in line with the agreement to base the Qatari Hawk aircraft in the UK. A Qatar Typhoon aircraft completed its first flight in November, in advance of Typhoon deliveries commencing in 2022.

Eight deliveries of major units under the Kuwait Typhoon contract, secured by Italian Eurofighter partner Leonardo, were completed during the year. The five remaining Kuwait major unit deliveries are planned to be completed during 2022.

Production progresses to plan with ten front fuselages in build on the £1.3bn German Air Force order for 38 aircraft to replace its original Typhoon Tranche 1 aircraft, received at the end of 2020.

The UK Typhoon fleet continues to achieve the contracted flying hours under its ten-year partnership arrangement, and support to the Royal Air Force's UK fleet of Hawk fast jet trainer aircraft continues under an interim agreement. In the first half of 2022, the Company secured the follow-on arrangement valued at £590m.

Initial entry into service of the export standard electronically scanned European Common Radar was achieved in December with delivery of the first two Kuwait Typhoon aircraft by Leonardo, and this capability will be extended to Qatar in 2022. National radar variants for the UK, German, Italian and Spanish Air Forces will continue post completion of export standard radar development activities. The UK continues to fund development activity for the future UK Typhoon weapon system and sensors, as part of the Partner Nations' commitment to the ten-year Typhoon capability enhancement programme.

Future Combat Air System
The Tempest technology maturation programme is progressing well.

During the year, the Company secured an initial £250m order for the Future Combat Air System Concept & Assessment Phase. Working with industry partners and the Ministry of Defence, the contract will enable development of a range of digital concepts, embedding new tools and techniques to design, evaluate and shape the final design and capability requirements of Tempest.

The Defence Information business is well positioned for future opportunities across the multi-domain, information and digital areas identified in the UK Defence Command Paper.

US Programmes
F-35 rear fuselage manufacturing reached full rate production during 2021 with 151 rear fuselage assemblies completed for the contracts Lots 12, 13, 14, and 15 in line with customer expectations. Pricing has now been agreed on Lots 15 to 17.

The global F-35 sustainment strategy continues to transition towards multi-year service agreements. In line with this, a five-year contract from January 2021 to December 2025 was awarded during the year, covering the provision of manpower services in support of key sustainment activities located in both the UK and the US.

Saudi Arabia
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, with examples of the benefits of the programme including our in-Kingdom employee base reflecting a 75% Saudisation rate, 94% of our in-Kingdom female employees being Saudi nationals and the development of our footprint across seven locations, resulting in demonstrable contributions to our local communities.

The Company is reliant on the continued approval of export licences by a number of governments in order to continue to support programme operations in the Kingdom of Saudi Arabia. We are working closely with industry partners and the UK government to continue to fulfil our contractual support arrangements in the Kingdom.

The Company continues to perform against the contract secured in 2018 to provide Typhoon support services to the Royal Saudi Air Force through to the end of 2022. Through this contract, the business also supports the Industrialisation of Defence capabilities in Saudi Arabia.

Strategic Report *(continued)*

Under the Saudi British Defence Cooperation Programme (SBDCP) agreement, the Company discharges a number of contracts, including support to the Tornado fleet, provision of officer and aircrew training and technician training for the Royal Saudi Air Force, as well as technical training, engineering and logistics services for the Royal Saudi Naval Forces. The current five-year SBDCP funding arrangement covering the provision of services to the Royal Saudi Air Force and Royal Saudi Naval Forces for the period 1 January 2022 to 31 December 2026 was signed by the governments of Saudi Arabia and the United Kingdom in December 2021. Initial orders have been received to ensure continuity of activities. Negotiations are progressing well and full contract award for these services is planned to be concluded during 2022.

As at the end of 2021, 19 of the contracted 22 Hawk aircraft assembled in-Kingdom have now been completed and formally accepted by the Royal Saudi Air Force, including 14 during the year. The remaining aircraft are scheduled to be accepted during the first half of 2022.

The Company continues to explore opportunities to collaborate with key local partners, including Saudi defence entities, to deliver further In-Kingdom Industrial Participation, in line with the Kingdom's National Transformation Plan and Vision 2030.

Key performance indicators

Key financial performance indicators are shown below:

	2021	2020
	£	£
Order intake	**4.4bn**	4.6bn
Revenue	**6.3bn**	6.1bn
Operating profit	**382m**	468m

Order intake represents funded orders received from customers in the year. The strong levels of order intake included Tempest Concept & Assessment phase award, Typhoon upgrades, further F-35 awards and Hawk support contract renewal in Australia.

Revenue represents the income derived from the provision of goods and services. The increase in revenue is driven by activity on the F-35 and Typhoon, as well as the ramp up in production on the Qatar Typhoon and Hawk programmes.

Operating profit represents profit for the year before income from subsidiary undertakings and participating interests, net finance costs and taxation expense. The increased research and development on programmes such as Tempest and the maturity mix of projects is driving the reduction in operating profit compared to 2020.

Strategic Report *(continued)*

Principal risks

The Company's principal risks are identified below.

The Company's largest customers are governments. The Company is dependent on government defence spending, and the timing and terms of trade of government contracts.

Defence spending
Description: 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. Defence spending by governments has also been impacted by the COVID-19 outbreak due to reprioritisation of funds.

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

Mitigation: The business is geographically spread across the UK and international defence markets. The diverse product and services portfolio is marketed across a range of defence markets. The Company benefits from a large order backlog, with established positions on long-term programmes in its principal markets.

Government contracting
Description: 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.

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

Mitigation: Government customers have sophisticated procurement and security organisations with which the Company can have long-standing relationships with well-established and understood terms of business. In the event of a customer terminating a contract for convenience, the Company would typically be paid for work done and commitments made at the time of termination.

Contract timing and milestones
Description: 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 timing of cash receipts could be impacted by the reprioritisation of government funds as a result of the outbreak of the COVID-19 pandemic.

Impact: Amounts receivable under the Company's defence contracts can be substantial and therefore, the timing of, or failure to receive, awards and associated cash advances and milestone payments could materially affect the Company's profits and cash flows for the periods affected, thereby reducing cash available to meet the Company's cash allocation priorities, potentially resulting in the need to arrange external funding and impacting its investment grade credit rating.

Mitigation: The Company's balance sheet continues to be managed conservatively in line with the BAE Systems Group policy to retain an investment grade credit rating and to ensure operating flexibility. The BAE Systems Group also monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet its operational needs and maintain adequate headroom.

The Company operates in international markets.

Description: The risks of operating in some countries include: social and political changes impacting the business environment; economic downturns, political instability and civil disturbances; the imposition of restraints on the movement of capital; the introduction of burdensome taxes or tariffs; change of export control and other government policy and regulations in the UK and all other relevant jurisdictions; and the inability to obtain or maintain the necessary export licences.

Impact: The occurrence of any such events could have a material adverse effect on the Company's future results and financial condition. The risk of the Company's inability to obtain and maintain the necessary export licences for its business in Saudi Arabia could affect the Company's provision of capability to the country.

Strategic Report *(continued)*

Principal risks *(continued)*

The Company operates in international markets. *(continued)*

Mitigation: The Company's contracts are often long-term in nature and consequently, it may be able to mitigate these risks over the term of those contracts. Political risk insurance is held in respect of export contracts not structured on a government-to-government basis.

Currency risk
Description: The Company is exposed to volatility arising from movements in currency exchange rates, particularly in respect of the US dollar, euro and Saudi riyal. There has been volatility in currency exchange rates in the period.

Impact: Significant fluctuations in exchange rates to which the Company is exposed could have a material adverse effect on the Company's future results and financial condition.

Mitigation: The Company's policy is to hedge all material firm transactional currency exchange rate exposures.

Brexit
Description: While the terms of the UK's relationship with the EU after the end of the transition phase on 31 December 2020 have now been clarified by the entry by the UK and the EU into the Trade and Cooperation Agreement, the UK is now a third country for the purposes of EU-funded defence projects. There remains the risk that, as a result of the UK leaving the EU, the Company's ability to take part in new European collaborative defence programmes, whether under such EU-funded projects or otherwise, could be hampered.

Impact: If the UK is excluded from new European collaborative defence programmes, this could impact the Company's future results and financial condition.

Mitigation: The Company benefits from a large order backlog with established positions on long-term programmes in the US, UK and Saudi Arabia and there is relatively limited UK-EU trading. The Company has key roles in major ongoing European programmes, such as Eurofighter, which are only likely to be marginally affected by Brexit. The Company will support the UK government in achieving its aim to ensure that the UK maintains its key role in European security and defence in the post-Brexit environment, and to strengthen bilateral relationships with key partners in Europe. This will be important for ongoing collaboration with such partners in Europe on the development of defence capabilities.

Contract risk, execution and supply chain.

Contract risk and execution
Description: A significant portion of the Company's revenue is derived from fixed-price contracts. Actual costs may exceed the projected costs, including assumptions on future rates of inflation, 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.

Impact: The inability of the Company to deliver on its contractual commitments, the loss, expiration, suspension, cancellation or termination of any one of its large contracts or its failure to anticipate technical problems or estimate accurately and control costs on fixed-price contracts could have a material adverse effect on the Company's future results and financial condition.

Mitigation: Contract-related risks and uncertainties are managed under the BAE Systems Group's mandated Lifecycle Management process. A leadership development programme for project directors continues to be deployed across the Company, covering the leadership competencies required to manage complex projects containing significant levels of risk and uncertainty. A significant proportion of the Company's largest contracts are with the UK Ministry of Defence. In the UK, development programmes are normally contracted with appropriate levels of risk being initially held by the customer and contract structures are used to mitigate risk on production programmes, including where the customer and contractor share cost savings and overruns against target prices. The Company has a well-balanced spread of programmes and significant order backlog which provides forward visibility. The Company has limited exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. Robust bid preparation and approvals processes are well established throughout the Company, with decisions required to be taken at the appropriate level in line with clear delegations of authority.

Supply chain
Description: The Company is dependent upon the delivery of materials by suppliers and the assembly of components and subsystems by subcontractors used in its products in a timely and satisfactory manner, on satisfactory commercial terms and in full compliance with applicable terms and conditions. The external supply chain environment is very dynamic at this time, with both lead-time and availability issues, but also pricing pressures, including from inflationary increases in labour, energy and other key materials.

Strategic Report *(continued)*

Principal risks *(continued)*

Contract risk, execution and supply chain. *(continued)*

Impact: Some of the Company's suppliers or subcontractors may be impacted by the economic environment (including inflationary pressures) which could impair their ability to meet their obligations to the Company and to supply on satisfactory commercial terms. In some instances, the Company is dependent on one or a limited number of suppliers. If any of these suppliers or subcontractors fail to meet the Company's needs, the Company may not, in the short term, have readily available alternatives, thereby impacting its ability to complete its customer obligations satisfactorily and in a timely manner. The above events could have a negative impact on the Company's future results of operations and financial condition.

Mitigation: The BAE Systems Group's procurement function is responsible for establishing and managing end-to-end integrated supplier arrangements. The BAE Systems Group Executive Committee continues to monitor this risk. In many cases, the Company benefits from long-term programme positions and incumbencies with more stable forward visibility for long-lead items allowing the Company to continue to actively manage supplier lead times against demand requirements. The Company seeks to manage the inflation risk through its contracting arrangements on many of its major programmes, effective cost management and improved efficiency of the Company's own operations and through its long-term supplier agreements.

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

Description: The Company's business plan depends upon its ability to win and contract for high-quality new programmes, an increasing number of which are expected to be in markets outside the UK. The Company is dependent upon UK government support in relation to a number of its business opportunities in export markets.

Impact: The Company's business and future results may be adversely impacted if it is unable to compete adequately and obtain new business in the markets in which it operates.

Mitigation: The Company has leading capabilities and a track record of delivery on its commitments to its customers. The Company continues to invest in research and development, and to reduce its cost base and improve efficiencies, to remain competitive. In the UK, export contracts can be structured on a government-to-government basis and government support can also involve military training, ministerial support for promotional activities and financial support through UK Export Finance.

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

Description: The COVID-19 pandemic has demonstrated the far reaching health, social and economic impacts of a global infectious disease outbreak. Although there has been an effective roll-out of vaccination programmes in certain countries, it is still not clear how long the pandemic will last or how enduring its consequences will be. The COVID-19 pandemic could also result in changes to the outlook in the Company's markets.

Impact: Contagious diseases, and the measures taken to control them, can have an adverse effect on the Company's employees, business, financial condition and results of operations. While the Company continues to liaise closely with its customers and suppliers to understand any changes in requirements and priorities, the uncertainties surrounding the future direction of the COVID-19 pandemic make it difficult to predict the extent to which the Company may be affected. Areas of the Group's business that could be impacted include a decrease in spending by the Company's major defence customers; an increase in taxation by governments; the failure to obtain awards for defence and commercial contracts; the failure of suppliers to deliver parts to the Company; the requirement for the Company or its suppliers to reduce site operational levels or close sites; 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 was 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.

Mitigation: Since the outbreak of the COVID-19 pandemic, the Company has taken a wide range of responsive measures, tailored to the individual countries in which it operates, including reducing site operational levels and introducing new cleaning regimes, safe working distance measures and protective equipment for our employees. The Company continues to build on the experience gained to date in dealing with the pandemic, including adapted safe working practices and the effective use of home working where appropriate.

By taking these measured actions to build in resilience for a prolonged period of disruption, the Company has continued to deliver critical work for its customers and, where operations were impacted, ensured that site-critical workers have now been able to safely return to work where possible. The Company is now adapting or removing COVID-19 controls where appropriate, having regard to relevant government guidance. Control measures could be re-introduced, should there be adverse developments in future.

Strategic Report *(continued)*

Principal risks *(continued)*

The outbreak of contagious diseases may have an adverse effect on the Company's business, financial condition and results of operations. *(continued)*

Support for the defence industry from the governments in the Company's key markets has been strong around prioritisation of capabilities, cash flows, recognising the need to maintain a strong supply chain and working collaboratively to maintain critical defence and security programmes.

The Company could be negatively impacted by threats to the security of its information technology and operational technology systems.

Description: The cyber security threats faced by the Company include: threats to the operation of its information technology (IT) and operational technology (OT) infrastructure and systems; unlawful attempts to gain access to both the Company's proprietary or classified information and that of its customers, partners and suppliers; and the potential for business disruptions associated with IT and OT failures.

Impact: Failure to combat these risks effectively could disrupt business operations, compromise the security of the Company's products and services, erode the Company's competitive advantage, and negatively impact the Company's reputation among its customers and the public, resulting in a negative impact on the Company's future results and financial condition.

Mitigation: The Company has a broad range of measures in place, including use of appropriate tools and techniques to monitor and mitigate the risks. Many of its networks and systems have to be configured and operated to meet government and customer requirements for storing, managing and processing the various different levels of government classified information handled by the Company.

The Company leverages BAE Systems' core specialist internal capabilities in information security, and combine it with our external market and intelligence knowledge, to ensure continued protection, and constant re-evaluation of the Company's security posture against targeted attacks and other evolving threats.

To complement the threat and data security risk activity, continual protective monitoring of the Company's networks is undertaken locally and by BAE Systems' Global Security Operations Centre for centralised analysis to protect the enterprise infrastructure. As well as monitoring for signs of external attack, the Company's protective monitoring also operates against Insider Threat activity, where user violations of security policy are detected and investigated.

A formal assurance programme, which is audited both internally and externally, is operated to check adherence to company standards and customer requirements.

Supplementing these mitigations is a programme of continuous employee education and awareness to help ensure employees understand applicable policies and act appropriately to mitigate the threats.

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

Description: Delivery of the Company's strategy and business plan is dependent on its ability to compete to recruit and retain people with appropriate talent and skills, including those with innovative technological capabilities. The 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.

Impact: The loss of key employees or inability to attract the appropriate people on a timely basis could adversely impact the Company's ability to deliver its strategy, meet the business plan and, accordingly, have a negative impact on the Company's future results and financial condition.

Mitigation: The Company recognises that its employees are key to delivering its strategy and business plan, and focuses on developing the existing workforce and hiring talented people to meet current and future requirements.

The Company has well-established graduate recruitment and apprenticeship programmes and, in order to maximise the contribution that its workforce can make to the performance of the business, has an effective through-career capability development programme.

In order to seek to maximise its talent pool, the Company is committed to creating a diverse and inclusive environment for its employees.

Strategic Report *(continued)*

Principal risks *(continued)*

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

Description: The latest estimates show that there is no longer a funding deficit in any of the pension schemes. A funding deficit could arise or be adversely affected by changes in a number of factors, including investment returns and members' anticipated longevity.

Impact: An increase in pension scheme liabilities or reduction in pension scheme assets could result in a pension scheme deficit which may require the Company to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet the Company's other cash allocation priorities.

Mitigation: New employees have been offered membership of defined contribution rather than defined benefit schemes since April 2012. The investment strategy in place aims to ensure that the pension scheme assets are invested such that they match the cash flows needed to meet the pension liabilities, thereby reducing the risk of a deficit arising. There are a number of longevity risk management strategies in place.

In October 2019 the assets and liabilities of six of the pension schemes were consolidated into a single scheme. This was carried out to drive long-term efficiencies. Following the merger, BAE Systems plc and Trustees agreed to carry out an early triennial funding valuation as at 31 October 2019. In February 2020 that valuation and deficit recovery plan were agreed with the Trustees after consultation with The Pensions Regulator in the UK. The funding deficit as at 31 October 2019 was £1.9bn. As part of the valuation agreement, the Company paid £1bn into the Scheme in April 2020, representing an advancement of £1bn of deficit contributions due between 2022 and 2026.

The UK triennial funding valuations for the other smaller UK pension schemes dated 31 March 2020 have been finalised and all of the schemes were in surplus requiring no further Company contributions to be made.

The Company may be impacted by environmental factors, including those relating to climate change.

Description: The Company is subject to comprehensive environmental laws and regulations in each of the countries in which it operates, including those relating to the impacts of climate change. Such laws and regulations impose standards with respect to air emissions, wastewater discharges, the use, handling and storage of hazardous materials and waste, remediation of soil and groundwater contamination and the prevention of pollution. They can also include energy-related taxes and the increased costs of compliance with energy-related schemes.

The Company may also be impacted by environmental factors, including physical risks arising from climate change, such as extreme weather events, for example flooding and storms, and scarcity of water and other resources. The Company may also be impacted by climate change transition risks resulting from the process of adjusting to a low carbon economy. Associated with this are potential risks around the Company's ability to attract and retain future talent.

Impact: Environmental factors, including those relating to climate change, have the potential to materially impact the Company's business and operations.

Increasing changes in environmental laws and regulations can expose the Company to increasing capital and operating costs associated with compliance, remediation and protection of the environment. Breaches of such laws and regulations can result in substantial costs, including fines, penalties or other sanctions, investigations and clean-up costs, and third-party claims for property damage or personal injury as well as the termination of permits.

Extreme weather events can impact the Company's operational sites as well of those of our suppliers. The shift to a low carbon economy has the potential to increase the cost of business as the Company transitions to lower emissions technologies and deals with the disposal of its legacy assets.

Mitigation: The Company has set itself the target of achieving net zero greenhouse gas emissions across its operations (Scope 1 and 2) by 2030 and working towards a net zero value chain by 2050. More generally, the Company has taken a business-led approach to setting reduction targets and driving improvement programmes and activities to reduce our environmental impacts.

The BAE Systems Group has an environmental management system in place for all of its businesses and short- and long-term risks relating to the environment and climate change, including those arising from current and emerging regulation, are built into these business environmental management systems. These systems enable the Company to define issues and set appropriate targets for the reduction of environmental and climate change impacts and risks.

Understanding how the business may be impacted by environmental factors is also a key component of how the Company seeks to mitigate emerging, medium- and longer-term risk.

Strategic Report *(continued)*

Principal risks *(continued)*

The Company may be impacted by environmental factors, including those relating to climate change.
(continued)

BAE Systems uses analytical tools to apply natural catastrophe classifications to its sites worldwide. This has informed the Company's strategy as to where to target a programme of specific flood, windstorm and earthquake assessments of its sites and implement the subsequent risk reduction recommendations.

In 2020, the Group conducted a refresh of this data and during 2021 modelled climate scenarios for 2030, 2050 and 2085. It has also begun to assess the natural hazard risks of its critical Tier 1 suppliers' sites.

During 2021, the Group further developed its understanding of the climate-related risk and opportunities with the potential to impact BAE Systems' business model and strategy as a result of the qualitative scenario modelling which has taken place. The Group is now starting to progress quantification of material risks and opportunities against identified climate scenarios.

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

Description: The Company operates in a highly-regulated environment across many jurisdictions and is subject, without limitation, to regulations relating to import-export controls, money laundering, false accounting, anti-bribery and anti-boycott provisions. It is important that the 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.

Impact: Failure by the Company, or its sales representatives, marketing advisers or others acting on its behalf, to comply with these regulations could result in fines and penalties and/or the suspension or debarment of the Company from government contracts or the suspension of the Company's export privileges, which could have a material adverse effect on the Company.

Reduced access to export markets could have a material adverse effect on the Company's future results and financial condition.

Mitigation: BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying restrictions that could adversely impact the Company's activities. Internal and external market risk assessments form an important element of ongoing corporate development and training processes. A uniform global policy and process for the appointment of advisers engaged in business development is in effect.

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

Strategic Report *(continued)*

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.

Keeping employees connected, informed and engaged has never been more important as the Company's employees continued to experience major impacts on their personal circumstances and ways of working through the pandemic. The Company used a range of channels to make sure its employees had access to the information and support they needed throughout the year, as well as keeping employees informed about the performance, developments and prospects of the business and the BAE Systems Group. This included engagement through the Group intranet, employee app, email, videos, podcasts, newsletters, leadership communications, virtual discussions and briefings, and through our line managers who played a key role in keeping their teams connected and engaged. This includes continuing to focus on two-way communications, ensuring there are channels through which employees can express their views, feedback and any concerns, helping the Company understand employee sentiment on an ongoing basis and respond appropriately.

Other notable examples in 2021 of employee engagement included a full employee survey and monthly employee voice sessions to understand the 'mood' of the business. The sentiment gathered through these activities was shared with senior leaders and helped to shape and develop appropriate action.

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 11, 18, 23, 56 to 58 and 153 of BAE Systems plc's Annual Report 2021 (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.

The Company's largest customers are governments and it also sells to large prime contractors. Strong and collaborative relationships with the Company's principal government customers helps the Company to identify its customers' requirements and to help position the Company as a trusted provider. The Managing Director of the main business of the Company, who is a Director of the Company, is 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. The value of long-term supplier partnerships was shown during 2021, with the Group's long-term global supply agreements, put in place prior to the pandemic, being of particular assistance in maintain supply of critical components. A pro-active approach was taken to manage supplier relationships with the Group working closely with suppliers to anticipate issues and take action where possible to ensure continuity of supply.

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 the Company builds and nurtures mutually beneficial relationships between its business, its people and local stakeholders. Giving back to the communities in which the Company operates, and to charities that have meaning to its business, is vitally important to the Company and its employees, allowing the Company 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 also 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 and the UK, BAE Systems Group education ambassadors have offered their time to encourage school-age children to pursue STEM subjects and careers.

As a manufacturer, the Company recognises that its operations have an impact on the environment – from the energy and resources it uses, to the products it manufactures and the waste that it generates. As an organisation, the BAE Systems Group is committed to reducing the environmental impact of its operations and products, minimising its environmental footprint and, in turn, decreasing its operational costs. Through the Operational Framework the Company implements the requirements of the BAE Systems Group's Environmental Policy, which details the Group's commitment to high standards of environmental management. In particular, the Company is supporting the Group's target of achieving net zero greenhouse gas emissions across the Group's operations (scope 1 and 2) by 2030 and its target of working towards a net zero value chain by 2050.

All of the above 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 "Climate change and the environment" and "Social" sections (pages 38 to 47 and 50 to 63 respectively) of BAE Systems plc's Annual Report 2021 (available at: www.baesystems.com/investors).

Strategic Report *(continued)*

Maintaining a reputation for high standards of business conduct

The BAE Systems Group aims to be a recognised leader in business conduct which helps it 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 the business 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 2021 (available at: www.baesystems.com/investors) and in particular the "Governance" section on pages 64 to 67.

Approved by the Board and signed on its behalf by:

P S Inman
Director
24 June 2022

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 £317m (2020 £311m). Please see page 4 within the Strategic Report for further information.

The Directors propose a dividend for 2021 of £315m (2020 £310m). The dividend proposed per share is 31.26p (2020 30.77p.

Looking forward

Future Typhoon production and support sales are underpinned by existing contracts. Discussions continue in relation to potential further contract awards for Typhoon. Production of rear fuselage assemblies for the F-35 has reached full rate levels and is expected to be sustained at these current levels. The Company plays a significant role in the F-35 sustainment programme in support of Lockheed Martin. The UK Combat Air Strategy provides the base to enable long-term planning an 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. Our in-Kingdom support business is expected to remain stable underpinned by long-standing contracts renewed every five years.

In order to provide ongoing capability to international customers, the Company is reliant on the continued support of export licences by a number of governments. The withholding of such export licences may have an adverse effect on the Group's provision of capability to the Kingdom of Saudi Arabia and the Group will continue to work closely with the UK government to manage the impact of any such occurrence.

Events after the reporting period

Since the Balance Sheet date, several countries in which we operate have announced or are making plans to increase spending to counter the elevated and evolving threat environment on multiple fronts. This has been determined to be a non-adjusting post balance sheet event. It is not currently possible for the Company to estimate the potential future financial impact of such changes.

Since the Balance Sheet date, there has been an increase globally in supply chain and inflationary pressures for businesses. This has been determined to be a non-adjusting post balance sheet event. Owing to the uncertainty around supply chain and inflationary pressures, we have included this as a principal risk in this report. The Company is currently mitigating the major financial impacts of this issue and seeks to continue to do so.

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.

The Company and its ultimate parent entity BAE Systems plc continue to conduct ongoing risk assessments in relation to their business operations and liquidity, including in relation to the potential future impact of the COVID-19 pandemic.

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 11 of the Strategic Report.

Directors' Report *(continued)*

Employees *(continued)*

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.

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 £575m (2020 £475m), of which £166m (2020 £140m) was funded by the Company.

Energy and Carbon Reporting exemption
The Company has taken advantage of the exemption granted under The Companies Act (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 as this information is disclosed in the annual report of its ultimate parent, BAE Systems plc on pages 38 to 47.

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 12 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 set out its purpose, which connects to its strategy – see page 1 of the BAE Systems Annual Report 2021 (available at: www.baesystems.com/investors). The 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.

Directors' Report *(continued)*

Corporate governance statement *(continued)*

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.

Those requirements ensure that internal controls are in place and documented 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 Leadership framework is a core business process designed to enable business performance and support delivery of the Group's strategy. It is an integrated set of activities, supporting people managers with identifying, selecting, managing, developing and rewarding employees across the Group and is required to be implemented within the businesses 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.

Directors' Report *(continued)*

Corporate governance statement *(continued)*

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.

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 (resigned 9 August 2021)
Mr P S Inman (appointed 9 August 2021)
Mr C G Boardman (resigned 31 December 2021)
Mr C M Robson (appointed 1 January 2022)
Ms A J Thompson
Mr T Fillingham
Mr M Taylor (resigned 31 March 2022)

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 they ought to have taken to make themselves 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:

P S Inman
Director

24 June 2022

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 2021 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

In auditing the Financial Statements, we have concluded that the Directors' use of the going concern basis of accounting in the preparation of the Financial Statements is appropriate.

Our evaluation of the Directors' assessment of the Company's ability to continue to adopt the going concern basis of accounting included:

- understanding the cash position of the Company and the extent to which the company is reliant on Group support for liquidity purposes;
- testing the accuracy of management's models, including agreement to the most recent approved budgets and forecasts;
- challenging the key assumptions of these forecasts by assessing analyst reports/industry data and other external information, comparing forecast revenue with the company's order book and historical performance, evaluating the historical accuracy of forecasts prepared by management and assessing the sensitivity of these forecasts;
- assessing the sufficiency of the Company's disclosure surrounding the going concern basis.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, *individually or collectively, may cast significant doubt on the Company's ability to continue as a going concern for a* period of at least twelve months from when the Financial Statements are authorised for issue.

Our responsibilities and the responsibilities of the Directors with respect to going concern are described in the relevant sections of this report.

Other information

The other information comprises the information included in the annual report, other than the Financial Statements and our auditor's report thereon. The Directors are responsible for the other information contained within the annual report. 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.

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

Report on the audit of the Financial Statements *(continued)*

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 course of 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 this gives rise to a material misstatement in the Financial Statements themselves. 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 this regard.

Responsibilities of Directors

As explained more fully in the Directors' Responsibilities Statement, the Directors are responsible for the preparation of the Financial Statements and for being satisfied that they give a true and fair view, and for such internal control as the Directors determine is necessary to enable the preparation of Financial Statements that are free from material misstatement, whether due to fraud or error.

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

Extent to which the audit was considered capable of detecting irregularities, including fraud

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below.

We considered the nature of the Company's industry and its control environment, and reviewed the Company's documentation of their policies and procedures relating to fraud and compliance with laws and regulations. We also enquired of management about their own identification and assessment of the risks of irregularities.

We obtained an understanding of the legal and regulatory framework that the Company operates in, and identified the key laws and regulations that:
- had a direct effect on the determination of material amounts and disclosures in the Financial Statements, which included the UK Companies Act, pension legislation and tax legislation; and
- do not have a direct effect on the Financial Statements, but compliance with which may be fundamental to the Company's ability to operate or to avoid a material penalty, including in respect of export controls, defence contracting and anti-bribery and corruption legislation.

We discussed among the audit engagement team regarding the opportunities and incentives that may exist within the organisation for fraud and how and where fraud might occur in the Financial Statements.

In common with all audits under ISAs (UK), we are also required to perform specific procedures to respond to the risk of management override. In addressing the risk of fraud through management override of controls, we tested the appropriateness of journal entries and other adjustments; assessed whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluated the business rationale of any significant transactions that are unusual or outside the normal course of business.

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

Report on the audit of the Financial Statements *(continued)*

In addition to the above, our procedures to respond to the risks identified included the following:

- reviewing financial statement disclosures by testing to supporting documentation to assess compliance with provisions of relevant laws and regulations described as having a direct effect on the Financial Statements;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- enquiring of management concerning actual and potential litigation and claims, and instances of non-compliance with laws and regulations; and
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with relevant regulatory authorities.

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

John Adam (Senior Statutory Auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom
24 June 2022

Income Statement
for the year ended 31 December

	Notes	**2021 £m**	2020 £m
Revenue	2	**6,253**	6,062
Operating costs	3	**(5,910)**	(5,661)
Other income	4	**39**	67
Operating profit		**382**	468
Financial income	5	**27**	17
Financial expense	6	**(40)**	(81)
Profit before tax		**369**	404
Taxation expense	8	**(52)**	(93)
Profit for the year		**317**	311

Statement of Comprehensive Income
for the year ended 31 December

	Notes	**2021 £m**	2020[1] £m
Profit for the year		**317**	311
Other comprehensive income			
Items that will not be reclassified to the Income Statement:			
Remeasurements on post-employment benefit schemes	21	**1,162**	(587)
Tax on items that will not be reclassified to the Income Statement	8	**(148)**	169
Items that may be reclassified to the Income Statement:			
Currency translation on foreign currency branches	23	**-**	(6)
Fair value gain arising on hedging instruments during the period	23	**20**	19
Cumulative fair value (gain)/loss on hedging instruments reclassified to the income statement	23	**(22)**	31
Tax on items that may be reclassified to the Income Statement	8	**-**	2
Total other comprehensive profit/(loss) for the year (net of tax)		**1,012**	(372)
Total comprehensive profit/(loss) for the year		**1,329**	(61)

1. Prior year comparatives have been re-presented to separately present amounts on matured hedging instruments recognised through profit and loss within the period. An analysis of other reserves is provided in note 23.

The notes on pages 25 to 62 form part of the Financial Statements.

The results for 2021 and 2020 arise from continuing activities.

Balance Sheet
as at 31 December

	Notes	**2021 £m**	2020 £m
Non-current assets			
Intangible assets	9	**109**	139
Property, plant and equipment	10	**416**	419
Right-of-use assets	11	**160**	172
Investment property	12	**54**	54
Investments in subsidiary undertakings and participating interests	13	**1**	1
Other receivables	14	**6,543**	6,265
Post-employment benefit surpluses	21	**51**	39
Other financial assets	15	**93**	53
Deferred tax assets	16	**331**	510
		7,758	7,652
Current assets			
Inventories	17	**195**	223
Trade, other and contract receivables	14	**1,829**	2,656
Other financial assets	15	**112**	101
Current tax	18	**76**	33
Cash and cash equivalents		**9**	11
		2,221	3,024
Total assets		**9,979**	10,676
Non-current liabilities			
Lease liabilities	11	**(224)**	(238)
Contract liabilities	19	**(230)**	(297)
Other payables	20	**(22)**	(31)
Post-employment benefit obligations	21	**(1,121)**	(2,259)
Other financial liabilities	15	**(91)**	(41)
Provisions	22	**(16)**	(15)
		(1,704)	(2,881)
Current liabilities			
Lease liabilities	11	**(18)**	(18)
Contract liabilities	19	**(1,751)**	(2,162)
Trade and other payables	20	**(3,780)**	(3,872)
Other financial liabilities	15	**(82)**	(76)
Provisions	22	**(51)**	(78)
		(5,682)	(6,206)
Total liabilities		**(7,386)**	(9,087)
Net assets		**2,593**	1,589
Capital and reserves			
Issued share capital	23	**1,008**	1,008
Share premium		**25**	25
Other reserves	23	**17**	53
Retained earnings		**1,543**	503
Total equity		**2,593**	1,589

Approved by the Board on 24 June 2022 and signed on its behalf by:

P S Inman
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 1 January 2021		1,008	25	53	503	1,589
Profit for the year		-	-	-	317	317
Total other comprehensive (loss)/income for the year		-	-	(2)	1,014	1,012
Total comprehensive (loss)/ income for the year		-	-	(2)	1,331	1,329
Share-based payments (inclusive of tax)	25	-	-	-	19	19
Cumulative fair value gain on hedging instruments transferred to the balance sheet (net of tax)	23	-	-	(34)	-	(34)
Ordinary share dividends		-	-	-	(310)	(310)
At 31 December 2021		**1,008**	**25**	**17**	**1,543**	**2,593**
Balance at 1 January 2020		1,008	25	43	592	1,668
Profit for the year		-	-	-	311	311
Total other comprehensive (loss)/ income for the year		-	-	46	(418)	(372)
Total comprehensive (loss)/income for the year		-	-	46	(107)	(61)
Share-based payments (inclusive of tax)	25	-	-	-	18	18
Cumulative fair value gain on hedging instruments transferred to the balance sheet (net of tax)	23	-	-	(36)	-	(36)
At 31 December 2020		**1,008**	**25**	**53**	**503**	**1,589**

1. Prior year comparatives have been re-presented to separately present amounts on matured hedging instruments recognised through profit and loss within the period. An analysis of other reserves is provided in note 23.

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 17. 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, which is the entity's functional currency, 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 requirements of paragraphs 52, the second sentence of paragraph 89, and paragraphs 90, 91 and 93 of IFRS 16 Leases.
- 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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

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.

Key sources of estimation uncertainty
The application of the Company's accounting policies requires the use of estimates. The impact of the COVID-19 pandemic on economic activity has been, and is expected to continue to be, significant. While the Company has addressed the impact on its business effectively to date, it continues to conduct ongoing risk assessments and scenario planning in order that it can respond to potential rapid changes in circumstances, given the continuing uncertainty relating to the impact of the pandemic. While this uncertainty continues, the Company will need to consider a range of estimates and assumptions in the application of its accounting policies and management's assessment of the carrying values of assets and liabilities. In the event that these estimates or assumptions prove to be incorrect, there may be an adjustment to the carrying values of assets and liabilities within the next year. Potential areas of the Company's financial statements which could be materially impacted may include, but are not limited to:

Accounting policy	Description
Revenue and profit recognition	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. The ultimate profitability of contracts is based on estimates of revenue and costs, including allowances for technical and other risks including the impacts of COVID-19 and climate change, 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. 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. The impact of the COVID-19 pandemic has increased uncertainty in relation to these judgements and estimates. The Company continues to work closely and collaboratively with its key customers to continue to deliver effectively on its contracts and commitments. However, the volume, scale, complexity and long-term nature of its programmes mean that a range of calculated potential sensitivities would be wide-ranging and not practicable to calculate. Owing to the ongoing uncertainty regarding the future impact of the COVID-19 pandemic, the Company's estimates and assumptions relating to revenue could be impacted by issues such as reduced productivity as a result of altered working practices to comply with safety and social distancing requirements, production delays and increased costs as a result of disruption to the supply chain or where there is uncertainty as to the recovery from customers of programme costs incurred. As shown in note 2, the Company has recognised £0.2bn of revenue in respect of performance obligations satisfied or partially satisfied in previous periods (2020 £0.2bn). This continues to provide an approximation of the potential revenue sensitivity arising as a result of management's estimates and assumptions for variable consideration, future costs, and technical and other risks, however may not reflect the full potential impact on the contract receivables and contract liabilities balances.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Key sources of estimation uncertainty *(continued)*

Valuation of post-employment benefit obligations	A number of actuarial assumptions are made in assessing the value of post-employment benefit obligations, including discount rate, inflation rate, and mortality assumptions. For each of the actuarial assumptions used there is a wide range of possible values and management estimates a point within that range that most appropriately reflects the Company's circumstances. If estimates relating to these actuarial assumptions are no longer valid or change due to changing economic and social conditions, which could be impacted by the longer-term implications of the COVID-19 pandemic, then the potential obligations due under these schemes could change significantly. Discount and inflation rates could change significantly as a result of a prolonged economic downturn, monetary policy decisions and interventions or other macro-economic issues resulting from the pandemic. The impact of estimates made with regard to mortality projections may also change significantly, given the uncertainty in this area resulting from the pandemic. Similarly, the values of many assets are subject to estimates and assumptions, in particular those which are held in unquoted pooled investment vehicles. The associated fair value of these unquoted pooled investments is estimated with consideration of the most recently available valuations provided by the investment or fund managers. These valuations inherently incorporate a number of assumptions including the risk associated with the COVID-19 pandemic and the impact of climate change on the underlying investments. The overall level of estimation uncertainty in valuing these assets could therefore give rise to a material change in valuation within the next 12 months. Note 21 provides information on the key assumptions and analysis of their sensitivities.

In preparing the consolidated financial statements management has considered the potential impact of climate change, in the context of the disclosures included in the Strategic report this year and the Company's net zero targets. These considerations did not have a material impact on the financial reporting judgements and estimates. The following additional areas of estimation were considered in reaching this conclusion:

- estimates of future cash flows to support impairment assessments of the carrying value of non-current assets and the assessment of going concern and the longer-term viability of the Company;
- an assessment of the useful economic lives of assets; and
- potential climate-related impacts on the Company's environmental provisions, in particular with regard to legislative changes.

Judgements made in applying accounting policies
In the course of preparing the Financial Statements and when applying its accounting policies, the Company has been required to make judgements with regard to the actions required to enable the business to continue to meet customers' requirements, in an operating environment still dominated by the uncertainties arising from the COVID-19 pandemic. 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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Changes in accounting policies
Several standards, interpretations and amendments to existing standards became effective on 1 January 2021, none of which had a material impact on the Company.

The following standards, interpretations and amendments to existing standards became effective on 1 January 2021 and have not had a material impact on the Company:
– Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16: Interest Rate Benchmark Reform (Phase 2), effective from 1 January 2021; and
– Amendments to IFRS 4 Insurance Contracts: deferral of IFRS 9, effective from 1 January 2021.

The following amendments to existing standards have been issued and became effective in the year as a response to the COVID-19 pandemic, but did not have a material impact on the Company:
– Amendment to IFRS 16 Leases: Covid-19-Related Rent Concessions beyond 30 June 2021, effective from 1 April 2021 and adopted by the UK Secretary of State for Business, Energy and Industrial Strategy on 21 May 2021.

The following other standards, interpretations and amendments to existing standards have been issued but were not mandatory for accounting periods beginning on 1 January 2021. These are expected to be endorsed by the UK Endorsement Board and are not expected to have a material impact on the Company:
– IFRS 17 Insurance Contracts, effective from 1 January 2023 (not yet endorsed by the UK);
– Amendments to IFRS 17: Insurance Contracts, effective from 1 January 2023 (not yet endorsed by the UK);
– Amendments to IAS 1: Presentation of Financial Statements, effective from 1 January 2023 (not yet endorsed by the UK);
– Amendments to IFRS 3: Business Combinations, effective from 1 January 2022 (not yet endorsed by the UK);
– Amendments to IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors, effective from 1 January 2023 (not yet endorsed by the UK);
– Amendments to IAS 12: Income Taxes, effective from 1 January 2023 (not yet endorsed by the UK);
– Amendments to IAS 16: Property, Plant and Equipment, effective from 1 January 2022 (not yet endorsed by the UK);
– Amendments to IAS 37: Provisions, Contingent Liabilities and Contingent Assets, effective from 1 January 2022 (not yet endorsed by the UK); and
– Annual Improvements to IFRS Standards 2018-2020 Cycle, effective from 1 January 2022 (not yet endorsed by the UK).

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.

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.

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. Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events and circumstances.

The Company typically enters into the following types of contracts with customers:
– to design, build or create assets uniquely available to the customer such as aircraft;
– to service or maintain assets over a period of time; and
– to offer bespoke services to customers, for example through training.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Revenue and profit recognition *(continued)*
Revenue is recognised against each of these types of contracts in line with the following accounting policies.

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. A provision for warranties is recognised when the underlying products and services are sold (see note 22 for further detail).

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 variable price mechanisms, 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.

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 including the impact of COVID-19 and climate change. 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 appropriately depicts the Company's performance in transferring control of the goods and services to the customer.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Revenue and profit recognition *(continued)*
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.

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Leases *(continued)*
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 trade and asset 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.

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Intangible assets *(continued)*
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.

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

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..

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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.

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 post-employment benefit schemes or when post-employment benefits are paid.

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

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.

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 retirement benefit surpluses and obligations recognised in the Company's Balance Sheet represents 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 53. The bid values of scheme assets are not intended to be realised in the short term and may be subject to significant change before they are realised. The present values of scheme liabilities are derived from cash flow projections over long periods and are, therefore, inherently uncertain.

IAS 19 Employee Benefits limits the measurement of a defined benefit surplus to the lower of the surplus in the defined benefit scheme and the asset ceiling. The asset ceiling is the present value of any economic benefits available in the form of refunds from the scheme or reductions in future contributions to the scheme. IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, issued in 2007, provides an interpretation of the requirements of IAS 19, clarifying that a refund is available if the entity has an unconditional right to a refund in certain circumstances. The 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 2021.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Post-employment benefits *(continued)*
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.

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.

Notes to the Financial Statements *(continued)*

2 Revenue

Revenue by customer location

	2021 £m	2020[1] £m
United Kingdom	**478**	474
Rest of Europe	**1,087**	893
Saudi Arabia[1]	**2,400**	2,569
Qatar[1]	**1,007**	901
Rest of Middle East[1]	**176**	179
USA and Canada	**1,061**	1,002
Asia and Pacific	**41**	39
Africa, and Central and South America	**3**	5
	6,253	6,062

1. Amounts relating to revenue recorded in the Middle East has been split between Saudi Arabia, Qatar and the Rest of Middle East. 2020 comparatives have been re-presented on this basis.

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 2021 was £12.7bn (2020 £14.7bn).

Revenue of £0.2bn (2020 £0.2bn) was recognised during the year ended 31 December 2021 in respect of performance obligations satisfied or partially satisfied in previous periods.

3 Operating costs

	2021 £m	2020 £m
Raw materials, subcontracts and other bought-in items used	**4,110**	3,900
Change in inventories of finished goods and work-in-progress	**26**	57
Staff costs (note 7)	**1,047**	1,016
Depreciation	**65**	67
Amortisation	**27**	24
Impairment of intangible assets and investment property	**9**	-
Other operating charges	**626**	597
Operating costs	**5,910**	5,661

The remuneration of the auditor for the year ended 31 December 2021 for auditing of the Financial Statements was £1.0m (2020 £0.9m) in respect of audit work and £nil (2020 £0.1m) in respect of non-audit work.

Operating costs includes research and development expenditure of £166m (2020 £140m) funded by the Company.

Notes to the Financial Statements *(continued)*

4 Other income

	2021 £m	2020 £m
Research and development expenditure credits	**8**	25
Operating lease income from investment property	**6**	5
Profit on disposal of investment property	**-**	3
Management recharges	**2**	2
Impairment write-back of investment property (note 12)	**1**	5
Other	**22**	27
Other income	**39**	67

5 Financial income

	2021 £m	2020 £m
Interest income on finance lease receivables (note 11)	**1**	2
Interest income in respect of loans to BAE Systems plc Group subsidiaries	**16**	15
Interest income on cash and other financial instruments	**10**	-
Financial income	**27**	17

6 Financial expense

	2021 £m	2020 £m
Interest expense on lease liabilities (note 11)	**7**	7
Net interest expense on post-employment benefit obligations (note 21)	**32**	37
Fair value loss on hedging	**1**	37
Financial expense	**40**	81

Notes to the Financial Statements *(continued)*

7 Employees

The monthly average number of Company employees was as follows:

	2021 Number of employees	2020 Number of employees
Air	**13,764**	13,397
Electronic Systems	**1,443**	1,462
HQ	**50**	38
	15,257	14,897

The aggregate staff costs of Company employees were as follows:

	2021 £m	2020 £m
Wages and salaries	**798**	795
Social security costs	**75**	67
Pension costs – defined contribution plans (note 21)	**22**	13
Pension costs – defined benefit plans (note 21)	**128**	118
Other post-employment benefit costs (note 21)	**5**	5
Share-based payments (note 25)	**19**	18
	1,047	1,016

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

	2021 £'000	2020 £'000
Directors' remuneration	**2,908**	2,247
Amounts receivable under long-term incentive schemes	**-**	64
Company contributions to defined contribution pension schemes	**7**	45
Company contributions to defined benefit pension schemes	**244**	336
Directors' compensation for loss of office	**245**	-
	3,404	2,692

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

	2021 Number of Directors	2020 Number of Directors
Money purchase schemes	**2**	-
Defined benefit schemes	**4**	6

	2021 Number of Directors	2020 Number of Directors
Number of Directors who exercised share options	**5**	5
Number of Directors in respect of whose qualifying services shares were received or receivable under long-term incentive schemes	**5**	6

Notes to the Financial Statements *(continued)*

7 Employees *(continued)*

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

	2021	2020
	£'000	£'000
Remuneration and amounts receivable under long-term incentive schemes	**982**	841
Company contributions to defined benefit pension schemes	**117**	135

The highest paid Director's defined benefit accrued pension and accrued lump sum at 31 December 2021 was £275,000 (2020 £230,007) and £nil (2020 £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 (2020 £nil).

8 Tax

Tax expense

	2021	2020
	£m	£m
Current tax		
UK:		
Current tax	**(48)**	(65)
Adjustments in respect of prior years	**(1)**	(29)
Total current tax	**(49)**	(94)
Deferred tax		
Origination and reversal of temporary differences	**(7)**	(4)
Adjustments in respect of prior years	**(1)**	2
Tax rate adjustment[1]	**5**	3
Total deferred tax	**(3)**	1
Tax result	**(52)**	(93)

1. The Government announced in 2021 that from 1 April 2023 the UK corporation tax rate would increase from 19% to 25%. The deferred tax asset at each Balance Sheet date has been calculated at the tax rates, enacted at that date, expected to apply to the temporary differences when they reverse. The resulting tax rate adjustment has been partly recorded in the Income Statement, and partly in the Statement of Comprehensive Income.

Notes to the Financial Statements *(continued)*

8 Tax *(continued)*

Total tax reconciliation

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

	2021 £m	2020 £m
Profit before tax	**369**	404
UK corporation tax rate	**19.00%**	19.00%
Expected tax (expense)	**(70)**	(77)
Expenses not tax effected	**(1)**	-
Income not subject to tax	**22**	4
Research and development expenditure credits and patent box benefits	**1**	1
Imputed interest	**(7)**	(5)
Losses received from fellow Group companies	**-**	8
Adjustments in respect of prior years	**(2)**	(27)
Tax rate adjustment[1]	**5**	3
Tax result	**(52)**	(93)

Tax recognised in other comprehensive income

	2021			2020		
	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	**1,162**	**(215)**	**947**	(587)	126	(461)
Tax rate adjustment[1]	**-**	**67**	**67**	-	43	43
Items that may be reclassified to the Income Statement:						
Currency translation on foreign currency branches	**-**	**-**	**-**	(6)	-	(6)
Fair value gain arising on hedging instruments during the period[2]	**20**	**1**	**21**	19	1	20
Cumulative fair value (gain)/loss on hedging instruments reclassified to the income statement[2]	**(22)**	**(1)**	**(23)**	31	2	33
Tax rate adjustment[1]	**-**	**-**	**-**	-	(1)	(1)
	1,160	**(148)**	**1,012**	(578)	170	(408)

1. The Government announced in 2021 that from 1 April 2023 the UK corporation tax rate would increase from 19% to 25%. The deferred tax asset at each Balance Sheet date has been calculated at the tax rates, enacted at that date, expected to apply to the temporary differences when they reverse. The resulting tax rate adjustment has been partly recorded in the Income Statement, and partly in the Statement of Comprehensive Income.
2. Prior year comparatives have been re-presented to separately present amounts on matured hedging instruments recognised through profit and loss within the period. An analysis of other reserves is provided in note 23.

Notes to the Financial Statements *(continued)*

8 Tax *(continued)*

Tax recognised in other comprehensive income *(continued)*

	2021			2020		
	Other reserves £m	**Retained earnings £m**	**Total £m**	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Post-employment benefit schemes	-	26	26	-	43	43
	-	26	26	-	43	43
Deferred tax						
Financial instruments	-	-	-	2	-	2
Post-employment benefit schemes	-	(241)	(241)	-	83	83
Tax rate adjustment[1]	-	67	67	(1)	43	42
	-	(174)	(174)	1	126	127
Tax on other comprehensive income	-	(148)	(148)	1	169	170

1. The Government announced in 2021 that from 1 April 2023 the UK corporation tax rate would increase from 19% to 25%. The deferred tax asset at each Balance Sheet date has been calculated at the tax rates, enacted at that date, expected to apply to the temporary differences when they reverse. The resulting tax rate adjustment has been partly recorded in the Income Statement, and partly in the Statement of Comprehensive Income.

9 Intangible assets

	Goodwill £m	Software £m	Development costs £m	Other £m	Total £m
Cost					
At 1 January 2021	29	192	15	4	240
Additions:					
Internally developed	-	1	-	-	1
Acquired separately	-	6	-	-	6
At 31 December 2021	**29**	**199**	**15**	**4**	**247**
Amortisation and impairment					
At 1 January 2021	-	83	14	4	101
Amortisation charge	-	26	1	-	27
Impairment charge	-	10	-	-	10
At 31 December 2021	**-**	**119**	**15**	**4**	**138**
Net book value					
At 31 December 2021	**29**	**80**	**-**	**-**	**109**
At 31 December 2020	29	109	1	-	139

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, as well as the impact of evolving issues such as COVID-19, climate change and Brexit. Pre-tax discount rates, derived from the Company's post-tax weighted average cost of capital and adjusted for risks specific to the market in which the cash-generating unit operates, have been used in discounting these projected risk-adjusted cash flows.

Capital commitments
At 31 December 2021, capital expenditure of £2m (2020 £1m) 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			
At 1 January 2021	124	919	1,043
Additions	5	40	45
Disposals	(4)	(31)	(35)
At 31 December 2021	**125**	**928**	**1,053**
Depreciation and impairment			
At 1 January 2021	45	579	624
Depreciation charge for the year	4	43	47
Disposals	(2)	(32)	(34)
At 31 December 2021	**47**	**590**	**637**
Net book value			
At 31 December 2021	**78**	**338**	**416**
At 31 December 2020	79	340	419
Non-depreciated assets (included above):			
Assets in the course of construction			
At 31 December 2021	**11**	**105**	**116**
At 31 December 2020	16	100	116

Capital commitments
At 31 December 2021, capital expenditure of £34m (2020 £28m) in respect of property, plant and equipment was contracted but not provided for in the Financial Statements.

11 Leases

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 2021			31 December 2020		
	Land and buildings £m	**Plant and machinery £m**	**Total £m**	Land and buildings £m	Plant and machinery £m	Total £m
Additions during the year	**1**	**1**	**2**	-	2	2
Depreciation expense for the year	**12**	**1**	**13**	12	2	14
Net book value	**158**	**2**	**160**	170	2	172

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.

	2021 £m	2020 £m
Payments due:		
Within one year	**25**	25
Between one and five years	**94**	93
Later than five years	**173**	193
Total: undiscounted lease liabilities	**292**	311
Deduct: impact of discounting	**(50)**	(55)
Lease liabilities	**242**	256

The total cash outflow for leases in the year ended 31 December 2021, including short-term leases and low-value leases, amounted to £25m (2020 £26m).

Amounts recognised in the Income Statement

	2021 £m	2020 £m
Included in operating costs:		
Depreciation on right-of-use assets	**(13)**	(14)
	(13)	(14)
Included in other income:		
Operating lease income from investment property	**6**	5
	6	5
Included in net finance costs:		
Interest income on finance lease receivables	**1**	2
Interest expense on lease liabilities	**(7)**	(7)
	(6)	(5)

Finance lease receivables
Certain of the Company's subleases where the Company is an intermediate lessor are 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.

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	**2021 £m**	2020 £m
Receipts due:			
Within one year		**4**	3
Between one and two years		**4**	4
Between two and three years		**4**	4
Between three and four years		**4**	4
Between four and five years		**4**	4
Later than five years		**7**	11
Total undiscounted gross receipts		**27**	30
Deduct: Impact of discounting		**(2)**	(3)
Finance lease receivables	14	**25**	27

Notes to the Financial Statements *(continued)*

12 Investment property

	£m
Cost	
At 1 January 2021	63
Additions	4
At 31 December 2021	**67**
Depreciation and impairment	
At 1 January 2021	9
Depreciation charge for the year	5
Impairment write-back for the year	(1)
At 31 December 2021	**13**
Net book value	
At 31 December 2021	**54**
At 31 December 2020	54
Fair value	
At 31 December 2021	**59**
At 31 December 2020	58

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

Net book value	£m
At 1 January and 31 December 2021	**1**

Subsidiary undertakings and participating interests at 31 December 2021
In accordance with Section 409 of the Companies Act 2006, a full list of subsidiary undertakings and significant holdings as at 31 December 2021 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 (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

	2021 £m	2020[1] £m
Non-current		
Contract receivables	**5**	2
Amounts owed by parents of BAE Systems (Operations) Limited[1,2]	**6,074**	5,817
Amounts owed by other Group subsidiaries[1,2]	**385**	353
Prepayments	**12**	52
Finance lease receivables (note 11)	**22**	24
Other receivables	**45**	17
	6,543	6,265
Current		
Contract receivables	**702**	667
Trade receivables	**388**	1,029
Amounts owed by subsidiaries of BAE Systems (Operations) Limited[1,2]	**6**	6
Amounts owed by other Group subsidiaries[1,2]	**38**	94
Amounts owed by BAE Systems Group joint ventures (note 24)	**27**	58
Prepayments	**237**	416
Accrued income	**4**	56
Finance lease receivables (note 11)	**3**	3
Other receivables	**424**	327
	1,829	2,656

1. Amounts owed by BAE Systems plc and its subsidiaries have been split out into amounts owed by parents of BAE Systems (Operations) Limited, amounts owed by subsidiaries of BAE Systems (Operations) Limited and amounts owed by other Group subsidiaries. 2020 comparatives have been re-presented on this basis.
2. Amounts owed by subsidiary undertakings are repayable on demand. However, those which are not expected to be settled within the next 12 months have been presented as non-current. Whilst the majority of these payables are interest free, certain balances bear interest priced on an arm's length basis.

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

15 Other financial assets and liabilities

	2021		2020	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**93**	**(91)**	53	(41)
Current				
Cash flow hedges – foreign exchange contracts	**112**	**(82)**	101	(76)

Notes to the Financial Statements *(continued)*

16 Deferred tax

Deferred tax assets

	Deferred tax assets		Deferred tax liabilities		Net deferred tax balances	
	2021	2020	**2021**	2020	**2021**	2020
	£m	£m	**£m**	£m	**£m**	£m
Property, plant and equipment	**19**	17	**-**	-	**19**	17
Provisions and accruals	**5**	14	**-**	-	**5**	14
Post-employment benefit schemes						
Deficits	**253**	406	**-**	-	**253**	406
Additional contributions spread forward	**59**	79	**-**	-	**59**	79
Share-based payments	**1**	1	**-**	-	**1**	1
Financial instruments	**-**	-	**(6)**	(7)	**(6)**	(7)
Deferred tax assets/(liabilities)	**337**	517	**(6)**	(7)	**331**	510
Set off of assets/(liabilities)	**(6)**	(7)	**6**	7	**-**	-
Net deferred tax assets	**331**	510	**-**	-	**331**	510

Movement in temporary differences during the year

	At 1 January 2021 £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2021 £m**
Property, plant and equipment	17	2	-	**19**
Provisions and accruals	14	(9)	-	**5**
Post-employment benefit schemes				
Deficits	406	2	(154)	**254**
Additional contributions spread forward	79	-	(20)	**59**
Share-based payments	1	-	-	**1**
Financial instruments	(7)	-	-	**(7)**
	510	(5)	(174)	**331**

	At 1 January 2020 £m	Recognised in income £m	Recognised in equity £m	At 31 December 2020 £m
Property, plant and equipment	18	(1)	-	17
Provisions and accruals	12	2	-	14
Post-employment benefit schemes				
Deficits	359	-	47	406
Additional contributions spread forward	-	-	79	79
Share-based payments	1	-	-	1
Financial instruments	(8)	-	1	(7)
	382	1	127	510

The Government announced in 2021 that from 1 April 2023 the UK corporation tax rate would increase from 19% to 25%. The deferred tax asset at each Balance Sheet date has been calculated at the tax rates, enacted at that date, expected to apply to the temporary differences when they reverse. The resulting tax rate adjustment has been partly recorded in the Income Statement, and partly in the Statement of Comprehensive Income.

Notes to the Financial Statements *(continued)*

17 Inventories

	2021 £m	2020 £m
Work-in-progress	**24**	39
Raw materials and consumables	**168**	177
Finished goods and goods for resale	**3**	7
	195	223

The Company recognised £nil as a write down of inventories to net realisable value (2020 £nil).

18 Current tax

	2021 £m	2020 £m
Tax provisions	**(39)**	(44)
Research and development expenditure credits receivable	**66**	50
Other	**49**	27
	76	33
Represented by:		
Current tax assets	**76**	33
Current tax liabilities	**-**	-
	76	33

19 Contract liabilities

	2021 £m	2020 £m
Non-current		
Contract liabilities	**230**	297
Current		
Contract liabilities	**1,751**	2,162

Revenue recognised in the year includes £1,834m (2020 £2,211m) that was included in the opening contract liabilities balance.

Non-current and current contract liabilities as at 1 January 2020 were £459m and £2,482m, respectively.

The reduction in contract liabilities since 2020 is primarily due to utilisation of customer advances during the year.

Notes to the Financial Statements *(continued)*

20 Trade and other payables

	2021 £m	2020[1] £m
Non-current		
Amounts owed to BAE Systems Group joint ventures (note 24)	**7**	11
Accruals	**15**	20
	22	31
Current		
Trade payables	**98**	97
Amounts owed to parents of BAE Systems (Operations) Limited[1,2]	**2,174**	1,867
Amounts owed to other Group subsidiaries[1,2]	**328**	479
Amounts owed to BAE Systems Group joint ventures (note 24)	**15**	187
Other taxes and social security costs	**62**	378
Accruals	**969**	784
Deferred income	**31**	10
Other payables	**103**	70
	3,780	3,872

1. Amounts owed by BAE Systems plc and its subsidiaries have been split out into amounts owed by parents of BAE Systems (Operations) Limited, amounts owed by subsidiaries of BAE Systems (Operations) Limited and amounts owed by other Group subsidiaries. 2020 comparatives have been re-presented on this basis.
2. Amounts owed to subsidiary undertakings are repayable on demand. Whilst the majority of these payables are interest free, certain balances bear interest priced on an arm's length basis.

21 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. 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 54.

At 31 December 2021, the weighted average duration of the UK defined benefit pension obligations was 17 years (2020 18 years).

The Company participates in the following BAE Systems plc schemes: BAE Systems Pension Scheme (Main Scheme), Royal Ordnance Pension Scheme.

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]	13	19	68

1. Source: 31 October 2019 actuarial valuation reports.
2. Source: Royal Ordnance Pension Scheme actuarial valuation 31 March 2020.

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

Regulatory framework

The funded UK schemes are registered and subject to the statutory scheme-specific funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and 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. A further UK High Court judgment was delivered on 20 November 2020 which rules that past cash-equivalent transfer values needed to account for gender equalisation for the effect of GMPs. In 2018 and 2020, 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 2021, an allowance was included within the pension deficit which is a consistent proportion of the UK liabilities as applied in prior years and reflects the updated UK IAS 19 valuations as at 31 December 2021.

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 2021.

Funding

Introduction
Disclosures in respect of pension funding provided below reflect the pension schemes as a whole. Disclosures in respect of pension accounting under IAS 19 are provided on pages 53 to 58.

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 professionally qualified independent actuaries and include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 53. 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.

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

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 2020 £bn
Market value of assets	20.6	2.1
Present value of liabilities	(22.5)	(2.0)
Funding (deficit)/surplus	(1.9)	0.1
Percentage of accrued benefits covered by the assets at the valuation date	92%	105%

The valuations in 2019 and 2020 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 – 91
Life expectancy of a male currently aged 45 (years)	87 – 91
Life expectancy of a female currently aged 45 (years)	89 – 92

The discount rate assumptions used in the 2019 and 2020 valuations were directly based on prudent levels of expected returns for the assets held by the schemes, reflecting the planned investment strategies and maturity profiles of each scheme. The discount rates are curves which provide a different rate for each year into the future.

The inflation assumptions were derived using data from the Bank of England which is based on the difference between the yields on index-linked and fixed interest long-term government bonds. The inflation assumption is a curve which provides a different rate for each year into the future.

The funding valuations resulted in a significantly lower deficit than under IAS 19, largely due to lower liabilities reflecting the higher discount rate assumption. Under IAS 19, the discount rate for accounting purposes is based on third-party AA corporate bond yields whereas, for funding valuation purposes, the discount rate is based on a prudent level of expected returns from the broader and mixed types of investments reflected in the schemes' investment strategies, which are expected overall to yield higher returns than bonds.

The 2019 funding agreement is underpinned by a contingency plan, which includes a commitment by 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 pension schemes in the year ended 31 December 2021 were £186m (2020 £834m).

Notes to the Financial Statements *(continued)*

21 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.	The investment portfolios are highly diversified, investing in a wide range of assets, in order to reduce the exposure of the total portfolio to a materially adverse impact from a single security or type of security. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities. Some 50% (2020 48%) 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. 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, in line with the prior year. The strategy also caps the upside if equity markets increase more than an agreed percentage.
Interest rate risk Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, the UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk. The current level of interest rate protection is expressed as a hedge ratio of 79.0% (2020 72.4%). 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.
Inflation risk Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk. The current level of inflation protection is expressed as a hedge ratio of 107.8% (2020 100.2%). 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. In 2014, the Main Scheme implemented a pension increase exchange to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases.
Longevity risk Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees. In 2013, with the agreement of 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.

Notes to the Financial Statements *(continued)*

21 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.

	2021	2020	2019
Financial assumptions			
Discount rate – past service (%)	**1.9**	1.4	2.1
Discount rate – future service (%)	**1.9**	1.6	2.2
Retail Prices Index (RPI) Inflation (%)	**3.1**	2.7	2.8
Rate of increase in salaries (%)	**3.1**	2.7	2.8
Rate of increase in deferred pensions (%)	**2.4/3.1**	2.0/2.7	2.0/2.8
Rate of increase in pensions in payment (%)	**1.7 – 3.7**	1.6 – 3.6	1.5 – 3.6
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	**86 – 89**	86 – 88	87 – 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)	**86 – 90**	87 – 89	88 – 89
Life expectancy of a female currently aged 45 (years)	**89 – 91**	89 – 91	89 – 91

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 49.

Retail Prices Index (RPI) and Consumer Prices Index (CPI) 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. Index-linked government bonds contain a premium that investors are willing to pay to mitigate the risk that RPI inflation is higher than expected. To account for this, the RPI assumption includes an inflation risk premium deduction.

As a consequence of RPI reform announcements the Company has reviewed its approach to setting inflation assumptions. The inflation risk premium deduction has been set at 0.55% per annum (2020 0.5%) and the CPI assumption has been set at 0.7% per annum (2020 0.7%) lower than RPI. The resulting RPI assumption is 3.1% per annum and the CPI assumption is 2.4% per annum. The 0.7% per annum RPI-CPI differential is a weighted average of a 1% per annum differential pre-2030 and 0.1% per annum differential post-2030; this reflects the anticipated change to the RPI index from 2030.

Rate of increase in salaries
The rate of increase in salaries for the UK schemes is assumed to be RPI inflation of 3.1% (2020 2.7%), plus a promotional scale.

Rate of increase in deferred pensions
The rate of increase in deferred pensions is based on CPI inflation of 2.4% (2020 2.0%), with the exception of the legacy 2000 Plan, which is based on RPI inflation of 3.1% (2020 2.7%). 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.

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

Life expectancy
The Company has used the Self-Administered Pension Schemes S3 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 2020 tables (published by the Institute of Actuaries) have been used (in 2020, the Continuous Mortality Investigation 2019 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.0% (2020 1.0%), an initial rate adjustment parameter ('A') of 0.25% (2020 0.25%) in conjunction with a smoothing parameter ('Sk') of 7 for all members (2020 7). The Group has chosen to apply a weighting to the 2020 data in recognition of the abnormal excess deaths as a result of COVID-19. No further adjustments have been made to improvements expected in future years. The impacts of COVID-19 will continue to be monitored and assessed at future reporting dates.

The disclosures below are in respect of the Company's share of the IAS 19 deficit using the allocation methodology outlined on pages 35 to 36.

Summary of movements in post-employment benefit obligations

	Defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m
Company's share of IAS 19 deficit at 1 January 2021	(2,177)	(43)	(2,220)
Actual return on assets excluding amounts included in interest expense	1,133	-	1,133
Decrease in liabilities due to changes in assumptions and experience	29	-	29
Contributions in excess of service cost	24	-	24
Past service cost – plan amendments	(3)	-	(3)
Net interest expense	(31)	(1)	(32)
Foreign exchange adjustments	-	(1)	(1)
Company's share of IAS 19 deficit at 31 December 2021	**(1,025)**	**(45)**	**(1,070)**

Amounts recognised on the Balance Sheet

	2021			2020		
	Defined benefit pension schemes £m	**Saudi Arabia end of service benefit £m**	**Total £m**	Defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m
Present value of unfunded obligations	**(17)**	**(45)**	**(62)**	(32)	(43)	(75)
Present value of funded obligations	**(14,390)**	**-**	**(14,390)**	(14,564)	-	(14,564)
Fair value of scheme assets	**13,382**	**-**	**13,382**	12,419	-	12,419
Company's share of IAS 19 deficit, net	**(1,025)**	**(45)**	**(1,070)**	(2,177)	(43)	(2,220)
Represented by:						
Post-employment benefit surpluses	**51**	**-**	**51**	39	-	39
Post-employment benefit obligations	**(1,076)**	**(45)**	**(1,121)**	(2,216)	(43)	(2,259)
	(1,025)	**(45)**	**(1,070)**	(2,177)	(43)	(2,220)

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

Changes in the fair value of scheme assets

	Defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m
Company's share of the value of scheme assets at 1 January 2020	11,667	-	11,667
Interest income	238	-	238
Actual return on assets excluding amounts included in interest income	198	-	198
Actual return on assets	436	-	436
Contributions by employer	796	9	805
Contributions by employer in respect of employee salary sacrifice arrangements	38	-	38
Total contributions by employer	834	9	843
Members' contributions	3	-	3
Administrative expenses	(6)	-	(6)
Benefits paid	(515)	(9)	(524)
Company's share of the value of scheme assets at 31 December 2020	12,419	-	12,419
Interest income	169	-	169
Actual return on assets excluding amounts included in interest income	1,133	-	1,133
Actual return on assets	1,302		1,302
Contributions by employer	149	5	154
Contributions by employer in respect of employee salary sacrifice arrangements	37	-	37
Total contributions by employer	186	5	191
Members' contributions	3	-	3
Administrative expenses	(5)	-	(5)
Benefits paid	(523)	(5)	(528)
Company's share of the value of scheme assets at 31 December 2021	**13,382**	**-**	**13,382**

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

Assets of defined benefit pension schemes

	2021			2020		
	Quoted £m	**Unquoted £m**	**Total £m**	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	**624**	**-**	**624**	544	-	544
Overseas	**1,786**	**-**	**1,786**	1,448	-	1,448
Pooled investment vehicles[1]	**128**	**4,206**	**4,334**	431	3,533	3,964
Fixed interest securities:						
UK gilts	**468**	**-**	**468**	430	-	430
UK corporates	**822**	**1,624**	**2,446**	808	1,624	2,432
Overseas government	**35**	**-**	**35**	26	-	26
Overseas corporates	**543**	**26**	**569**	945	-	945
Index-linked securities:						
UK gilts	**1,436**	**-**	**1,436**	1,095	233	1,328
UK corporates	**-**	**631**	**631**	-	528	528
Property[2]	**-**	**1,009**	**1,009**	-	948	948
Derivatives[3]	**-**	**(475)**	**(475)**	-	(626)	(626)
Cash:						
Sterling	**483**	**15**	**498**	395	6	401
Foreign currency	**7**	**1**	**8**	12	1	13
Other	**16**	**(3)**	**13**	-	38	38
Company total	**6,348**	**7,034**	**13,382**	6,134	6,285	12,419

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.

Longevity swap

The Company holds longevity insurance contracts for some of its UK defined benefit pension schemes. These provide long-term protection and income to the underlying pension scheme in the event that insured members live longer than expected.

The value of the longevity insurance contracts held by the Company are calculated by an actuary. At a high level, they are measured by discounting the difference between the projected fixed and floating cash flows payable under the contracts, excluding the value of future projected fees. The significant assumptions used for this valuation are the discount rate and mortality assumptions; fair values for these assumptions are advised by an actuary based on external data and characteristics of the insured member population.

As at 31 December 2021, the longevity swap valuation leads to a negative adjustment to the assets which reflects that experience to date on the contracts has been higher than expected deaths.

Notes to the Financial Statements *(continued)*

21 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 £m	Total £m
Company's share of the defined benefit obligations at 1 January 2020	(13,893)	(53)	(13,946)
Transfer to other Group companies			
Current service cost	(106)	(5)	(111)
Contributions by employer in respect of employee salary sacrifice arrangements	(38)	-	(38)
Total current service cost	(144)	(5)	(149)
Members' contributions	(3)	-	(3)
Past service cost – plan amendments	(6)	-	(6)
Actuarial loss due to changes in assumptions and experience	(792)	7	(785)
Interest expense	(273)	(2)	(275)
Benefits paid	515	9	524
Foreign exchange translation	-	1	1
Company's share of the defined benefit obligations at 31 December 2020	(14,596)	(43)	(14,639)
Current service cost	(120)	(5)	(125)
Contributions by employer in respect of employee salary sacrifice arrangements	(37)	-	(37)
Total current service cost	(157)	(5)	(162)
Members' contributions	(3)	-	(3)
Past service cost – plan amendments	(3)	-	(3)
Actuarial gain due to changes in assumptions and experience	29	-	29
Interest expense	(200)	(1)	(201)
Benefits paid	523	5	528
Foreign exchange translation	-	(1)	(1)
Company's share of the defined benefit obligations at 31 December 2021	**(14,407)**	**(45)**	**(14,452)**

Amounts recognised in the Income Statement

	2021			2020		
	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	**(120)**	**(5)**	**(125)**	(106)	(5)	(111)
Past service cost – plan amendments	**(3)**	**-**	**(3)**	(6)	-	(6)
	(123)	**(5)**	**(128)**	(112)	(5)	(117)
Administrative expenses	**(5)**	**-**	**(5)**	(6)	-	(6)
	(128)	**(5)**	**(133)**	(118)	(5)	(123)
Included in finance costs:						
Net interest expense on post-employment benefit obligations	**(31)**	**(1)**	**(32)**	(35)	(2)	(37)

The Company incurred a charge of £22m (2020 £13m) in relation to defined contribution schemes for employees.

Notes to the Financial Statements *(continued)*

21 Post-employment benefits *(continued)*

Sensitivity analysis
The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2021 and keeping all other assumptions as set out on page 53.

The pension schemes hold a number of unquoted pooled investment vehicles, which are investments in private markets. These are valued based on latest available valuation reports, and as noted on page 27, these valuations are subject to estimation uncertainty as their valuation techniques incorporate a number of assumptions, including those associated with the COVID-19 pandemic and the impact of climate change.

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
0.5 percentage point increase	1.2	(0.6)
0.5 percentage point decrease	(1.3)	0.7
Inflation:		
0.1 percentage point increase	(0.2)	0.1
0.1 percentage point decrease	0.2	(0.1)
0.5 percentage point increase	(0.7)	0.5
0.5 percentage point decrease	0.7	(0.5)
1.0 percentage point increase	(1.5)	1.1
1.0 percentage point decrease	1.4	(0.9)

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)*

22 Provisions

	Warranties and after-sales service	Reorganisations	Legal, contractual and environmental	Other	Total
	£m	£m	£m	£m	£m
Non-current	11	2	2	-	15
Current	13	16	43	6	78
At 31 December 2020	24	18	45	6	93
Created	12	17	10	9	48
Released	(3)	(1)	(38)	(4)	(46)
Utilised	(6)	(13)	(8)	(1)	(28)
At 31 December 2021	**27**	**21**	**9**	**10**	**67**
Represented by:					
Non-current	13	-	2	1	16
Current	14	21	7	9	51
	27	**21**	**9**	**10**	**67**

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 £9m (2020 £9m) 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)*

23 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 2020, 31 December 2020 and 31 December 2021	**1,007,340**	**180**	**1,008**

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

The Directors propose a dividend of £315m for 2021 (2020 £310m). The dividend proposed per share is 31.26p (2020 30.77p.

Other reserves

	Hedging reserve £m	Translation reserve £m	Total £m
At 1 January 2020	43	-	43
Amounts credited to hedging reserve	15	-	15
Currency translation on foreign currency branches	-	(6)	(6)
Tax on amounts credited to hedging reserve	1	-	1
At 31 December 2020	59	(6)	53
Amounts credited to hedging reserve	(36)	-	(36)
Currency translation on foreign currency branches	-	(1)	(1)
Tax on amounts credited to hedging reserve	1	-	1
At 31 December 2021	**24**	**(7)**	**17**

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)*

24 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:

	Amounts owed to related party		Amounts owed by related party		Sales to related party		Purchases from related party	
Related party	**2021 £m**	2020 £m	**2021 £m**	2020 £m	**2021 £m**	2020 £m	**2021 £m**	2020 £m
International Systems Engineering Company Limited	**28**	26	**-**	-	**-**	-	**50**	25
Granada Enterprises Limited	**65**	-	**-**	-	**-**	-	**142**	-
Prismatic Limited	**-**	-	**-**	-	**-**	-	**-**	4
BAE Systems Saudi Development and Training Company Limited	**74**	147	**-**	-	**-**	-	**484**	536
Saudi Maintenance & Supply Chain Management Company Limited	**71**	108	**1**	-	**5**	-	**406**	438
Non wholly-owned BAE Systems Group subsidiaries	**238**	281	**1**	-	**5**	-	**1,082**	1,003
Advanced Electronics Company Limited	**-**	43	**-**	-	**-**	-	**-**	138
BAE Systems Strategic Aerospace Services WLL	**3**	1	**-**	-	**-**	-	**8**	-
Eurofighter Jagdflugzeug GmbH	**20**	21	**26**	57	**1,068**	897	**347**	337
MBDA SAS	**-**	133	**-**	-	**-**	-	**114**	187
Panavia Aircraft GmbH	**-**	-	**1**	1	**32**	35	**4**	4
Sealand Support Services Limited	**-**	-	**-**	-	**3**	4	**-**	-
Rheinmetall BAE Systems Land (RBSL)	**-**	-	**-**	-	**1**	1	**-**	-
BAE Systems Group joint ventures	**23**	198	**27**	58	**1,104**	937	**473**	666
BAE Systems Pension Funds Trustees Limited	**207**	162	**-**	-	**-**	-	**16**	15
BAE Systems Group pension schemes	**207**	162	**-**	-	**-**	-	**16**	15

25 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 2021.

For options outstanding at the end of the year:

	2021		2020	
	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**	**7**	3.89 – 6.49	8
Performance Share Plan	**-**	**5**	-	5

The average share price in the year was £5.33 (2020 £5.24).

Notes to the Financial Statements *(continued)*

26 Contingent liabilities

The Company has no individually significant contingent liabilities.

27 Events after the reporting period

Since the Balance Sheet date, several countries in which we operate have announced or are making plans to increase spending to counter the elevated and evolving threat environment on multiple fronts. This has been determined to be a non-adjusting post balance sheet event. It is not currently possible for the Company to estimate the potential future financial impact of such changes.

Since the Balance Sheet date, there has been an increase globally in supply chain and inflationary pressures for businesses. This has been determined to be a non-adjusting post balance sheet event. Owing to the uncertainty around supply chain and inflationary pressures, we have included this as a principal risk in this report. The Company is currently mitigating the major financial impacts of this issue and seeks to continue to do so.

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