BAE Systems (Oman) Limited

Annual Report and Financial Statements

31 December 2017

Registered Number: 03135337

Contents

Strategic Report

Review of business

Overview

In December 2012 BAE Systems (Oman) Limited (the "Company") was awarded a contract for the provision of Typhoon and Hawk Aircraft and attendant support services to the Sultanate of Oman. Deliveries to the customer under this contract commenced in 2017. The principal activities of the Company during the year have been the production and delivery of Typhoon and Hawk aircraft, the provision of aircraft spares, training and ground equipment and the commencement of a provision of long term, in-country support of the aircraft.

Key performance indicators

Key financial performance indicators are shown below:

	2017	2016
	£000	£000
Order intake	**1,731**	3,539
Revenue	**1,056,962**	616,462
Operating profit	**64,848**	34,217

Order intake represents the value of funded orders received from customers in the year. It is a measure of in-year performance and supports future years' sales performance.

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

Operating profit is used for internal performance analysis as a measure of operating profitability that is comparable over time.

Principal risks and uncertainties

The Company's principal risks are identified below.

The Company is dependent on defence spending.

The Company's core businesses are primarily defence-related, selling products and services to the Royal Air Force of Oman.

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

Some countries' economies may be influenced by oil prices, with consequent reduced defence spending.

The Company operates in an international market.

The Company conducts business in the Middle East.

The risks of operating in some countries include: political changes impacting the business environment; economic downturns, political instability and civil disturbances; changes in government regulations and administrative policies; the imposition of restraints on the movement of capital; the introduction of burdensome taxes or tariffs; and the inability to obtain or maintain the necessary export licences.

The Company is exposed to volatility in currency exchange rates, particularly in respect of the Omani Rial and US Dollar.

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

The Company operates in a highly-regulated environment across several 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 requirement 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 necessary export licences.

Strategic Report *(continued)*

The Company has few contracts, including two large contracts and several small contracts.

A significant portion of the Company's revenue is derived from fixed-price contracts. Actual costs may exceed the projected costs on which the fixed prices are agreed and, since these contracts can extend over many years, it can be difficult to predict the ultimate outturn costs.

It is important that the Company maintains a culture in which it delivers on its projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner.

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

The Company's profits and cash flows are dependent, to a significant extent, on the timing of, or failure to receive, award of defence contracts and the profile of cash receipts on its contracts.

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

In aggregate, there is an actuarial deficit between the value of the projected liabilities of BAE Systems' defined benefit pension schemes and the assets they hold.

The deficits may be adversely affected by changes in a number of factors, including investment returns, long-term interest rate and price inflation expectations, and anticipated members' longevity.

The Company's strategy is dependent on its ability to recruit and retain people with appropriate talent and skills. All employees are required to act in accordance with the Company's policies.

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.

It is important that the Company recruits and retains management with the necessary international skills and experience in the relevant jurisdictions.

On behalf of the Board

S D Wood
Director

04 June 2018

Directors' Report

Company registration

BAE Systems (Oman) Limited (the "Company") is a private company, limited by shares and registered in England and Wales with the registered number 03135337.

Results and dividends

The Company's profit for the financial year is £64,519k (2016 profit £34,054k). The directors propose a dividend of £76,000k for 2017 (2016 £nil).

Looking forward

The Company has a strong order backlog. Sales are underpinned by aircraft production and delivery of Typhoon and Hawk aircraft and the provision of long-term, in-country support of those aircraft.

Going concern

After making due enquiries, the directors have a reasonable expectation that the Company has adequate resources to continue operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Overseas branch office

The Company has an overseas branch office in Oman.

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.

Directors and their interests

The directors who served during the year and at the date of this Report were as follows:

Mr D A Cole (resigned 26 March 2018)

Mr I G King (resigned 30 June 2017)

Sir Simon Bryant KCB CBE

Mr S D Wood (appointed 9 October 2017)

Mr B W Ierland (appointed 26 March 2018)

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

Disclosure of information to auditor

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditor is unaware; and each director has taken all the steps that he ought to have taken to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

Auditor

Following an audit retender which concluded in 2017, Deloitte LLP was selected as the auditor for the BAE Systems Group. Accordingly it is intended that Deloitte LLP will be appointed to replace KPMG LLP as auditor for the year ending 31 December 2018.

On behalf of the Board

S D Wood
Director

04 June 2018

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

Statement of Directors' Responsibilities in respect of the Strategic Report, the Directors' Report and the Financial Statements

The directors are responsible for preparing the Strategic Report, 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 they have elected to prepare the financial statements in accordance with UK accounting standards and applicable law (UK Generally Accepted Accounting Practice), including 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;
- assess the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the 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 responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

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

Opinion

We have audited the financial statements of BAE Systems (Oman) Limited ("the Company") for the year ended 31 December 2017 which comprise the Income Statement, Statement of Comprehensive Income, Balance Sheet, Statement of Changes in Equity, and related notes, including the accounting policies in note 1. In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2017 and of its profit for the year then ended;
- have been properly prepared in accordance with UK accounting standards, including FRS 101 *Reduced Disclosure Framework;* and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We have fulfilled our ethical responsibilities under, and are independent of the Company in accordance with, UK ethical requirements including the FRC Ethical Standard. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion.

Going concern

We are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast significant doubt over the use of that basis for a period of at least twelve months from the date of approval of the financial statements. We have nothing to report in these respects.

Strategic Report and Directors' Report

The directors are responsible for the Strategic Report and the Directors' Report. Our opinion on the financial statements does not cover those Reports and we do not express an audit opinion thereon.

Our responsibility is to read the Strategic Report and the Directors' Report and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work:

- we have not identified material misstatements in the Strategic Report and the Directors' Report;
- in our opinion the information given in those Reports for the financial year is consistent with the financial statements; and
- in our opinion those Reports have been prepared in accordance with the Companies Act 2006.

Matters on which we are required to report by exception

Under the Companies Act 2006 we are required to report to you 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 these respects.

Directors' responsibilities

As explained more fully in their statement set out on page 6, the directors are responsible for: the preparation of the financial statements and for being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; 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 they either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

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

Auditor's responsibilities

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 our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not 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 aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

The purpose of our audit work and to whom we owe our responsibilities

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.

Richard Evans
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
KPMG LLP
1 St Peters Square
Manchester
M2 3AE

29 June 2018

Income Statement
for the year ended 31 December 2017

	Notes	2017 £000	2016 £000
Revenue	2	**1,056,962**	616,462
Operating costs	3	**(992,114)**	(582,245)
Profit before finance costs and tax		**64,848**	34,217
Financial expense	4	**(400)**	(200)
Profit before tax		**64,448**	34,017
Tax income	6	**71**	37
Profit for the year		**64,519**	34,054

Statement of Comprehensive Income
for the year ended 31 December 2017

	2017 £000	2016 £000
Profit for the year	**64,519**	34,054
Other comprehensive (expense) / income		
Items that will not be reclassified to the Income Statement:		
Remeasurements on retirement benefit schemes	**(3,400)**	(4,400)
Tax on items that will not be reclassified to the Income Statement	**578**	792
Tax rate adjustment	**-**	(70)
Items that may be reclassified to the Income Statement:		
Amounts (charged)/credited to hedging reserve	**(6,746)**	12,134
Tax on items that may be reclassified to the income statement	**1,328**	(2,184)
Tax rate adjustment	**-**	(229)
Total other comprehensive (expense) / income for the year (net of tax)	**(8,240)**	6,043
Total comprehensive income for the year	**56,279**	40,097

The notes on pages 12 to 30 form part of the financial statements.

The results for 2017 and 2016 arise from continuing activities.

Balance Sheet
as at 31 December 2017

	Notes	2017 £000	2016 £000
Non-current assets			
Intangible assets	7	**141**	80
Property, plant and equipment	8	**68**	105
Other financial assets	9	**8,583**	14,510
		8,792	14,695
Current assets			
Trade and other receivables including amounts due from customers for contract work	11	**347,923**	282,388
Other financial assets	9	**3,422**	4,151
Cash and cash equivalents		**361**	727
		351,706	287,266
Total assets		**360,498**	301,961
Non-current liabilities			
Retirement benefit obligations	13	**(11,012)**	(7,212)
Other financial liabilities	9	**(115)**	(129)
Deferred tax liabilities	10	**(305)**	(2,282)
		(11,432)	(9,623)
Current liabilities			
Trade and other payables	12	**(253,469)**	(253,124)
Other financial liabilities	9	**(383)**	(279)
		(253,852)	(253,403)
Total liabilities		**(265,284)**	(263,026)
Net assets		**95,214**	38,935
Capital and reserves			
Other reserves	14	**9,321**	14,739
Retained earnings		**85,893**	24,196
Total equity		**95,214**	38,935

Approved by the Board on 4 June 2018 and signed on its behalf by:

S D Wood
Director

Registered number: 03135337

Statement of Changes in Equity

for the year ended 31 December 2017

	Note	Other reserves	Retained earnings	Total equity
		£000	£000	£000
At 1 January 2016		5,018	(6,180)	(1,162)
Profit for the year		-	34,054	34,054
Total other comprehensive income for the year	14	9,721	(3,678)	6,043
At 31 December 2016		14,739	24,196	38,935
Profit for the year		-	64,519	64,519
Total other comprehensive income for the year	14	(5,418)	(2,822)	(8,240)
At 31 December 2017		**9,321**	**85,893**	**95,214**

Notes to the Financial Statements

1 Accounting policies

Basis of preparation

These financial statements were prepared in accordance with FRS 101 Reduced Disclosure Framework issued in September 2015. The amendments to FRS 101 (2015/16 cycle) issued in July 2016 and FRS 101 (2016/17 cycle) issued in July 2017 have no impact on the Company.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (IFRS) as adopted by the EU (EU-adopted IFRS), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken:

- the requirements of IFRS 7, Financial Instruments: Disclosures;
- 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; and
- 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.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

The following paragraphs summarise the main accounting policies of the Company and have, unless otherwise stated, been applied consistently to all periods presented in these financial statements.

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). As the Company has adequate resources to continue operational existence for the foreseeable future the going concern basis has been applied in these financial statements.

Future changes in accounting policies
IFRS 9, Financial Instruments, is effective from 1 January 2018. The standard covers recognition, classification, measurement and impairment of financial assets and financial liabilities, together with a new hedge accounting model.

IFRS 15, Revenue from Contracts with Customers, is effective from 1 January 2018. The standard requires the identification of performance obligations in contracts with customers and allocation of the total contractual value to each of the performance obligations identified. Revenue is recognised as each performance obligation is satisfied either at a point in time or over time. The standard will replace IAS 11, Construction Contracts, and IAS 18, Revenue.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

Revenue and profit recognition
Revenue represents income derived from the provision of goods and services by the Company.

Long-term contracts
The majority of the Company's long-term contract arrangements are accounted for under IAS 11, Construction Contracts. Sales are recognised when the Company has obtained the right to consideration in exchange for its performance, which is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed.

Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. No profit is recognised until the outcome of a contract can be reliably estimated. Profit is recognised progressively as risks have been mitigated or retired.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods supplied and services rendered
Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under a long-term contract is recognised in the Income Statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the Income Statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

Revenue and profits on intercompany trading are determined on an arms-length basis.

Dividends
Equity dividends paid on ordinary share capital are recognised as a liability in the period in which they are declared.

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 the foreign currency branch 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 foreign translation reserve.

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:

Computing equipment and motor vehicles	- 3 to 4 years

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.

Notes to the Financial Statements *(continued)*

1 Accounting policies *(continued)*

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

Trade and other receivables
Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

A loss on provision for bad debt is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of long-term contract balances for that portion of the work which has already been completed, and the remainder included as amounts due to long-term contract customers within provisions. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to Company performance, as cash received on customers' account.

Amounts due from contract customers represent unbilled income and are stated at cost plus attributable profit.

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 their 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 or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax
Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

- on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;
- related to investments in subsidiaries and equity accounted investments to the extent that it is probable that they will not reverse in the foreseeable future; and
- arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

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.

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 corporate 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)*

Retirement 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 25. 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.

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.

Financial instruments
Derivative financial instruments and hedging activities
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. The Company aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency 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. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the Income Statement for the period.

Cash flow hedges
Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction and recognised in the Income Statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the Income Statement immediately.

Notes to the Financial Statements *(continued)*

2 Segmental analysis

Revenue by customer location

	2017	2016
	£000	£000
Middle East	1,056,962	616,462
	1,056,962	616,462

Revenue by category

	2017	2016
	£000	£000
Long-term contracts	1,054,591	613,969
Sale of goods	195	2,074
Provision of services	2,176	419
	1,056,962	616,462

3 Operating costs

	2017	2016
	£000	£000
Raw materials, subcontracts and other bought-in items	972,469	577,161
Staff costs (note 5)	14,820	3,024
Depreciation, amortisation and impairment	56	42
Other operating charges	4,769	2,018
Operating costs	992,114	582,245

The remuneration of the auditor for the year ended 31 December 2017 for auditing of the financial statements was £10,000 (2016 £10,000) and £nil (2016 £nil) in respect of non-audit work.

4 Financial expense

	2017	2016
	£000	£000
Net interest expense on retirement benefit obligations (note 13)	400	200
Financial expense	400	200

5 Employees

The monthly average number of Company employees was 141 (2016: 32).

The aggregate staff costs of Company employees were as follows:

	2017	2016
	£000	£000
Wages and salaries	12,488	2,372
Social security costs	1,257	197
Pension costs – defined benefit plans (note 13)	1,018	400
Pension costs – defined contribution (note 13)	57	-
Other pension costs	-	55
	14,820	3,024

Notes to the Financial Statements *(continued)*

5 Employees *(continued)*

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

	2017	2016
	£'000	£'000
Directors' remuneration	**361**	252
	361	252

Retirement benefits are accruing to the following number of directors under:

	2017 Number of directors	2016 Number of directors
Money purchase schemes	**-**	-
Defined benefit schemes	**1**	-

	2017 Number of directors	2016 Number of directors
The number of directors who exercised share options was	**-**	-
The number of directors in respect of whose qualifying services shares were received or receivable under long-term incentive schemes was	**2**	1

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

	2017	2016
	£'000	£'000
Remuneration and amounts receivable under long-term incentive schemes	**337**	252

The highest paid director's defined benefit accrued pension and accrued lump sum at 31 December 2017 was nil (2016 £nil) and nil (2016 £nil), respectively.

Of the directors, I G King and D A Cole did not receive any emoluments from the Company during the year. They were employed by BAE Systems plc, and were remunerated through that company. They did not provide any material qualifying services to the Company.

Notes to the Financial Statements *(continued)*

6 Tax

	2017	2016
Deferred tax		
Origination and reversal of temporary differences	**67**	40
Adjustments in respect of prior years	**4**	-
Tax rate adjustment[1]	**-**	(3)
Tax result	**71**	37

The Company has not provided for current tax for the year as any taxable profits will be covered by the surrender of losses from fellow group companies, in respect of which no payment will be made.

[1]The UK corporation tax rate was reduced from 20% to 19% with effect from 1 April 2017, and will be reduced to 17% with effect from 1 April 2020. In line with these changes the deferred tax has been calculated at the tax rates that are expected to apply to temporary differences when they reverse, based on the laws enacted or substantially enacted by the reporting date.

Reconciliation of tax result

The following reconciles the expected tax result, using the UK corporation tax rate, to the reported tax result:

	2017 £000	2016 £000
Profit before taxation	**64,448**	34,017
UK corporation tax rate	**19.25%**	20%
Expected tax expense on result	**(12,406)**	(6,803)
Retirement benefit schemes	**(9)**	(6)
Imputed interest expense/(income)	**(687)**	433
Losses received from fellow group companies	**13,156**	6,409
Adjustments in respect of prior years	**4**	-
Other	**13**	4
Tax result	**71**	37

Tax recognised in other comprehensive income

	2017			2016		
	Before tax £000	**Tax benefit £000**	**Net of tax £000**	Before tax £000	Tax benefit/ (expense) £000	Net of tax £000
Items that will not be reclassified to the income statement:						
Remeasurements on retirement benefit schemes	**(3,400)**	**578**	**(2,822)**	(4,400)	792	(3,608)
Tax rate adjustment[1]	**-**	**-**	**-**	-	(70)	(70)
Items that may be reclassified to the income statement:						
Amounts (charged)/credited to hedging reserve	**(6,746)**	**1,328**	**(5,418)**	12,134	(2,184)	9,950
Fair value gain on available-for-sale financial assets	**-**	**-**	**-**	-	(229)	(229)
	(10,146)	**1,906**	**(8,240)**	7,734	(1,691)	6,043

Notes to the Financial Statements *(continued)*

6 Tax

	2017			2016		
	Other reserves	Retained earnings	Total	Other reserves	Retained earnings	Total
	£000	£000	£000	£000	£000	£000
Deferred tax						
Financial Instruments	1,328	-	1,328	(2,184)	-	(2,184)
Retirement benefit schemes	-	578	578	-	792	792
Tax rate adjustment	-	-	-	(229)	(70)	(299)
Tax on other comprehensive income	1,328	578	1,906	(2,413)	722	(1,691)

7 Intangible assets

	Software £000
Cost	
At 1 January 2017	80
Additions	80
At 31 December 2017	**160**
Amortisation	
At 1 January 2017	-
Amortisation charge	19
At 31 December 2017	**19**
Net book value	
At 31 December 2017	**141**
At 31 December 2016	80

8 Property, plant and equipment

	Plant and machinery £000	Total £000
Cost or valuation		
At 1 January 2017	199	199
At 31 December 2017	**199**	**199**
Depreciation and impairment		
At 1 January 2017	94	94
Depreciation charge for the year	37	37
At 31 December 2017	**131**	**131**
Net book value		
At 31 December 2017	**68**	**68**
At 31 December 2016	105	105

Capital commitments
Capital expenditure contracted for but not provided for in full in the financial statements is £nil (2016 £nil).

Notes to the Financial Statements *(continued)*

9 Other financial assets and liabilities

	2017		2016	
	Assets £000	**Liabilities £000**	Assets £000	Liabilities £000
Non-current				
Cash flow hedges – foreign exchange contracts	**8,583**	**(115)**	14,510	(129)
Current				
Cash flow hedges – foreign exchange contracts	**3,422**	**(383)**	4,151	(279)

Contracted cash flows
The net contractual cash flows on derivative financial instruments at the reporting date are £nil (2016 £nil).

10 Deferred tax

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2017	2016	**2017**	2016	**2017**	2016
	£000	£000	**£000**	£000	**£000**	£000
Property, plant and equipment	**9**	6	**-**	-	**9**	6
Retirement benefit schemes	**1,872**	1,226	**-**	-	**1,872**	1,226
Financial instruments	**-**	-	**(2,186)**	(3,514)	**(2,186)**	(3,514)
	1,881	1,232	**(2,186)**	(3,514)	**(305)**	(2,282)

Movement in temporary differences during the year

	At 1 January 2017 £000	Recognised in income £000	Recognised in equity £000	**At 31 December 2017 £000**
Property, plant and equipment	6	3	-	**9**
Retirement benefit schemes	1,226	68	578	**1,872**
Financial instruments	(3,514)	-	1,328	**(2,186)**
	(2,282)	71	1,906	**(305)**

	At 1 January 2016 £000	Recognised in income £000	Recognised in equity £000	At 31 December 2016 £000
Property, plant and equipment	3	3	-	6
Retirement benefit schemes	470	34	722	1,226
Financial instruments	(1,101)	-	(2,413)	(3,514)
	(628)	37	(1,691)	(2,282)

Notes to the Financial Statements *(continued)*

11 Trade and other receivables

	2017 £000	2016 £000
Current		
Long-term contract balances	**263,043**	864,496
Less: attributable progress payments	**(84,183)**	(690,398)
Amounts due from contract customers	**30,305**	10,113
Amounts due from customers for contract work	**209,165**	184,211
Trade receivables	**232**	240
Amounts owed by BAE Systems plc	**138,179**	97,447
Amounts owed by BAE Systems plc subsidiaries	**3**	130
Prepayments and accrued income	**344**	360
	347,923	282,388

12 Trade and other payables

	2017 £000	2016 £000
Current		
Trade payables	**1,386**	76
Amounts due to long-term contract customers	**92,394**	248,201
Amounts owed to BAE Systems plc	**772**	193
Amounts owed to BAE Systems plc subsidiaries	**151,438**	1,540
Accruals and deferred income	**6,404**	3,114
Other payables	**1,075**	-
	253,469	253,124
Included above:		
Advances from long-term contract customers	92,394	248,201

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations

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.

At 31 December 2017, the weighted average durations of the UK defined benefit pension obligations were 18 years (2016 19 years).

The Company participates in the following BAE Systems plc scheme: BAE Systems Pension Scheme (Main Scheme).

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme[1]	35	20	45

1. Source: Main Scheme actuarial valuation report as at 31 March 2017.

Regulatory framework
The funded UK schemes are registered and subject to the statutory scheme specific-funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and BAE Systems plc.

Benefits
The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The Normal Retirement Age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: www.baesystemspensions.com.

Funding

Valuations
The majority of the UK defined benefit pension schemes are funded by BAE Systems plc's subsidiaries and joint ventures. The individual pension schemes' funding requirements are based on actuarial measurement frameworks set out in their funding policies.

For funding valuation purposes, pension scheme assets are included at market value at the valuation date, whilst the liabilities are measured on an actuarial funding basis using the projected unit credit method and discounted to their present value based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The funding valuations are performed by professional qualified independent actuaries and include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 25. 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.

Funding valuations of the UK defined benefit schemes are performed every three years. The latest valuations were performed as at 31 March 2017. The next funding valuation will have an effective date of no later than 31 March 2020.

In November, the 2017 triennial funding valuations and, where necessary, deficit recovery plans were agreed with the trustees and certified by the scheme actuaries after consultation with the UK Pensions Regulator. The funding valuations have resulted in a significantly lower deficit than under IAS 19.

The results of the most recent triennial valuation at 31 March 2017 is shown below:

	Main Scheme £bn	Other schemes £bn	Total £bn
Market value of assets	12.8	8.8	21.6
Present value of liabilities	(14.4)	(9.3)	(23.7)
Funding deficit	(1.6)	(0.5)	(2.1)
Percentage of accrued benefits covered by the assets at the valuation date	89%	95%	91%

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

The valuations were determined using the following mortality assumptions:

	2017
Life expectancy of a male currently aged 65 (years)	86 – 89
Life expectancy of a female currently aged 65 (years	88 – 90
Life expectancy of a male currently aged 45 (years)	88 – 92
Life expectancy of a female currently aged 45 (years)	91 – 93

The discount rate assumptions are based on prudent levels of expected returns for the assets held by each of the schemes. The discount rates are curves which provide a different rate for each year into the future. The discount rates used in the 2014 valuation were based on a traditional gilts yield plus a margin which varied by scheme and over time. The discount rates used in the 2017 valuation are directly based on prudent return assumptions for the assets held by the schemes, reflecting the planned investment strategies and maturity profiles of each scheme.

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

In aggregate, the total net funding deficit across the UK schemes, prior to allocation to other participating employers, at 31 March 2017 was £2.1bn. The funding deficit is significantly lower than the accounting deficit of the equivalent UK schemes prepared 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 held in the schemes, which are expected to yield higher returns than bonds.

The agreements reached are underpinned by contingency plans, which include a commitment by BAE Systems plc to a further £50m of deficit funding into the largest scheme prior to the next triennial valuation in the event that the scheme funding level was to fall below pre-determined parameters. In addition, BAE Systems plc would be required to pay £187m across its schemes with deficits at the valuation date if the funding levels for those schemes were to fall significantly and were to remain at or below those levels for nine months.

There will be no change to the contributions or benefits, as set out in the rules of the schemes, for pension scheme members as a result of the new funding valuations.

The results of future triennial valuations and associated funding requirements will be impacted by a number of factors, including the future performance of investment markets and anticipated members' longevity.

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

The total Company contributions made to the defined benefit schemes in the year ended 31 December 2017 were £1.0m (2016 £0.4m) in line with the schedule of contributions.

Based on the new funding valuations, the total current annual deficit recovery payments to the UK schemes, including amounts funded by other participating employers, will increase to £220m a year from 1 April 2018. Deficit contributions will further increase in line with any percentage growth in dividend payments made by BAE Systems plc. Under the new deficit recovery plans, these annual payments would subsequently fall by £50m in 2022 as the deficits on certain schemes are expected to be cleared. The annual payments are expected to end in 2026 when all deficits are projected to be cleared. Under the last agreement made in 2014, all scheme deficits were projected to be cleared in 2026. Deficit recovery payments will be allocated to all participating employers based on the relative payroll contributions of active members.

In 2018, the Company expects to make total contributions to its pension schemes of £1m.

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

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 provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities. Some 51% (2016 50%) of the UKs 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 a long-dated equity option strategy protecting £1.4bn of assets against a significant fall in equity markets.
Interest rate risk	
Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, some of the UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk. The discount rate assumptions set as part of the 2017 UK funding valuations more directly reflect the expected returns on assets held by the schemes and, therefore, the liabilities are less sensitive to interest rate risk than they were in the 2014 funding valuation. Accordingly, the 2017 approach provides a more 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 2017 UK funding valuation, 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 approach to the 2017 UK funding valuation provides a more natural hedge against inflation movements and, therefore, the liabilities are less sensitive to inflation risk than they were in the 2014 funding valuation. Under the 2017 UK funding valuation approach, the Company is already fully hedged against inflation movements and, under the planned investment strategy, and aims to maintain a fully hedged position. In 2014, the Main Scheme implemented a pension increase exchange to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases.
Longevity risk	
Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees. In 2013, with the agreement of the BAE Systems plc, the trustees of the 2000 Plan, Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme entered into arrangements with Legal & General to insure against longevity risk for the current pensioner population, covering a total of £4.4bn of pension scheme liabilities. These arrangements reduce the funding volatility relating to increasing life expectancy.

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

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.

	2017	2016	2015
Financial assumptions			
Discount rate – past service (%)	**2.6**	2.7	3.9
Discount rate – future service (%)	**2.7**	2.7	3.9
Retail Prices Index (RPI) Inflation (%)	**3.1**	3.2	3.2
Rate of increase in salaries (%)	**3.1**	3.2	3.2
Rate of increase in deferred pensions (%)	**2.1/3.1**	2.2/3.2	2.3/3.2
Rate of increase in pensions in payment (%)	**1.6-3.7**	1.7-3.7	1.8 – 3.6
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	**86 – 88**	86 – 89	87 – 89
Life expectancy of a female currently aged 65 (years)	**88 – 90**	89 – 90	89 – 90
Life expectancy of a male currently aged 45 (years)	**88 – 90**	88 – 91	89 – 91
Life expectancy of a female currently aged 45 (years)	**90 – 92**	91 – 92	91 – 92

Discount rate
The discount rate assumptions are derived through discounting the projected benefit payments of the principal schemes using a third-party AA corporate bond yield curve to produce a single equivalent discount rate. This inherently captures the maturity profile of the expected benefit payments. The discount rate used for future service differs from that used for past service as it only uses the cash flows relating to active members, which have a different duration. Further information on the duration of the schemes is detailed on page 22.

Retail Prices Index (RPI) Inflation
The inflation assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information.

Rate of increase in salaries
The rate of increase in salaries for the UK schemes is assumed to be RPI inflation of 3.1% (2016 RPI inflation of 3.2%), plus a promotional scale.

Rate of increase in deferred pensions
The rate of increase in deferred pensions for the UK schemes is based on Consumer Prices Index (CPI) inflation of 2.1% (2016 CPI inflation of 2.2%). The rate of increase in deferred pensions is subject to inflation caps.

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

Life expectancy
The Company has used the Self-Administered Pension Schemes S2 mortality tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of scheme members and information on the demographic profile of the scheme's membership. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2016 tables (published by the Institute of Actuaries) have been used (in 2016, the Continuous Mortality Investigation 2015 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.25% (2016 1.25%), for both pensioner and non-pensioner members.

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

The disclosures below are in respect of the Company's share of the IAS 19 deficit after allocation to other participating employers.

Summary of movements in retirement benefit obligations

	£m
Company's share of IAS 19 deficit at 1 January 2017	(7)
Actual return on assets excluding amounts included in interest expense	25
Increase in liabilities due to changes in assumptions and experience	(29)
Company's share of IAS 19 deficit at 31 December 2017	**(11)**

Amounts recognised on the balance sheet
The table below shows the Company's share of the Group's UK pension schemes after allocation to other participating employers.

	2017 £m	2016 £m
Present value of funded obligations	**(58)**	(29)
Fair value of scheme assets	**47**	22
Company's share of IAS 19 (deficit), net	**(11)**	(7)
Represented by:		
Retirement benefit surpluses	**-**	-
Retirement benefit obligations	**(11)**	(7)
	(11)	(7)

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

Changes in the fair value of scheme assets after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's value of scheme assets at 1 January 2016	8.9
Interest income	0.7
Actual return on assets excluding amounts included in interest income	12.9
Actual return on assets	13.6
Contributions by employer	0.3
Contributions by employer in respect of employee salary sacrifice arrangements	0.1
Total contributions by employer	0.4
Members' contributions	-
Benefits paid	(0.9)
Company's value of scheme assets at 31 December 2016	22.0
Interest income	1.2
Actual return on assets excluding amounts included in interest income	24.9
Actual return on assets	26.1
Contributions by employer	0.9
Contributions by employer in respect of employee salary sacrifice arrangements	0.1
Total contributions by employer	1.0
Members' contributions	-
Benefits paid	(2.1)
Company's value of scheme assets at 31 December 2017	**47.0**

Assets of defined benefit pension schemes

	2017			2016		
	Quoted £m	**Unquoted £m**	**Total £m**	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	**11.1**	-	**11.1**	5.3	0.0	5.3
Overseas	**8.4**	**0.8**	**9.2**	3.8	0.0	3.8
Pooled investment vehicles[1]	-	**5.4**	**5.4**	0.3	2.3	2.6
Fixed interest securities:	-	-	-			
UK gilts	**2.4**	**0.1**	**2.5**	1.6	0.0	1.6
UK corporates	**4.1**	**2.3**	**6.4**	2.4	0.1	2.5
Overseas government	**0.1**	-	**0.1**	0.1	0.0	0.1
Overseas corporates	**3.0**	-	**3.0**	1.0	0.4	1.4
Index-linked securities:	-	-	-			
UK gilts	**3.2**	**0.2**	**3.4**	1.6	0.0	1.6
UK corporates	**1.2**	**1.0**	**2.2**	0.9	0.5	1.4
Property[2]	-	**3.8**	**3.8**	0.0	1.6	1.6
Derivatives[3]	-	**(0.9)**	**(0.9)**	0.0	(0.3)	(0.3)
Cash:	-	-	-			
Sterling	**0.5**	-	**0.5**	0.4	0.0	0.4
Foreign currency	-	-	-	0.0	0.0	0.0
Other	**0.1**	**0.2**	**0.3**	0.0	0.0	0.0
Company total	**34.1**	**12.9**	**47.0**	17.4	4.6	22.0

1. Primarily invested in equities. The amounts classified as unquoted primarily comprise investments in private equity, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.
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 interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

Changes in the present value of the defined benefit obligations after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's defined benefit obligations at 1 January 2016	(11.5)
Current service cost	(0.3)
Contributions by employer in respect of employee salary sacrifice arrangements	(0.1)
Total current service cost	(0.4)
Members' contributions	-
Past service cost – plan amendments	-
Actuarial (loss)/gain due to changes in assumptions and experience	(17.3)
Interest expense	(0.9)
Benefits paid	0.9
Company's defined benefit obligations at 31 December 2016	(29.2)
Current service cost	(0.9)
Contributions by employer in respect of employee salary sacrifice arrangements	(0.1)
Total current service cost	(1.0)
Members' contributions	-
Past service cost – plan amendments	-
Actuarial (loss)/gain due to changes in assumptions and experience	(28.3)
Interest expense	(1.6)
Benefits paid	2.1
Company's defined benefit obligations at 31 December 2017	**(58.0)**

Amounts recognised in the income statement after allocation to other participating employers

	2017 £000	2016 £000
Included in operating costs:		
Current service cost	**(1,018)**	(400)
	(1,018)	(400)
Included in finance costs/income:		
Net interest (expense) on retirement benefit obligations	**(400)**	(200)

The Company incurred a charge of £0.1 m (2016 £0.4m) in relation to defined contribution schemes for employees.

Notes to the Financial Statements *(continued)*

13 Retirement benefit obligations *(continued)*

Sensitivity analysis
The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2017 and keeping all other assumptions as set out on page 25.

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 scheme assets £m	(Increase)/ decrease in pension obligation £m
Discount rate:		
0.1 percentage point increase	-	1
0.1 percentage point decrease	-	(1)
Inflation:		
0.1 percentage point increase	-	(1)
0.1 percentage point decrease	-	1

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

	(Increase)/ decrease in pension obligation £m
Inflation:	
0.5 percentage point increase	(4)
0.5 percentage point decrease	3
1.0 percentage point increase	(7)
1.0 percentage point decrease	7

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 £m
Life expectancy:	
One-year increase	(2)
One-year decrease	2

Notes to the Financial Statements *(continued)*

14 Share capital and other reserves

Share capital

	£1 Ordinary shares No.	Nominal value £
Issued and fully paid		
At 1 January and 31 December 2017	**2**	**2**

Other reserves

	Hedging reserve £000
At 1 January 2016	**5,018**
Amounts credited to hedging reserve	12,134
Tax on other comprehensive income	(2,413)
At 31 December 2016	**14,739**
Amounts charged to hedging reserve	(6,746)
Tax on other comprehensive income	1,328
At 31 December 2017	**9,321**

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.

15 Controlling parties

The immediate parent company is BAE Systems (Holdings) Limited and the ultimate parent company is BAE Systems plc, which is the only parent company preparing group financial statements. Both companies are incorporated in Great Britain and registered in England and Wales.

The consolidated Annual Report of BAE Systems plc is available to the public and may be obtained from:

6 Carlton Gardens
London
SW1Y 5AD

Website: www.baesystems.com