

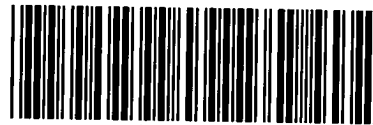
BAE Systems (Operations) Limited

Annual Report and Financial Statements

31 December 2023

Registered number: 01996687

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Strategic Report

for the year ended 31 December 2023

Principal activities

BAE Systems (Operations) Limited (the "Company") is a member of the BAE Systems plc Group ("BAE Systems Group" or "Group") of companies. It consists of the majority of the BAE Systems Group's Air sector (primarily UK-based air build and support activities for European and international markets, US programmes, development of Future Combat Air Systems and FalconWorks®, alongside some of our business in the Kingdom of Saudi Arabia), and the Group's Electronic Systems business based in Rochester, UK.

Review of business

Operational performance

The Company continues to work with our customers to support their existing platforms and provide new enhanced capabilities. Deliveries of Typhoon to Qatar continue, alongside support to the in-service fleet. In the Kingdom of Saudi Arabia, the Company's support for Typhoon has been extended for a further five-year term. In our US Programmes division, the Company is focused on delivery execution across all production lines with 162 F-35 aft fuselages completed in 2023. The formation of our new FalconWorks® organisation and ongoing progress on the future combat air activities are important to future growth as the Company invests in our people, facilities and cutting-edge technologies.

Operational highlights

Activity on the Company's Qatar Typhoon and Hawk programmes continued with 10 further Typhoon deliveries in the year, and a total of 18 aircraft were in service with the Qatar Emiri Air Force at the end of the year.

On Tempest, the UK's next generation fighter programme, the Company continues to work on developing the UK flying combat air demonstrator to fly within four years. The programme is focused on key technology areas of flight simulation, aerodynamic engine testing, and crew escape.

The Company's FalconWorks® organisation, formed during the year to develop and bring to the market new products and technologies, is leading the development and testing of PHASA-35®, the Company's persistent high altitude solar aircraft, with successful stratospheric flight trials taking place in June 2023.

The Company continues to deliver services under the five-year Saudi British Defence Co-operation Programme, with the Tornado Support Service providing an enhanced and modernised solution for the Royal Saudi Air Force.

Strategic and order highlights

Additional UK Ministry of Defence funding of c.£800m was awarded during the year, to advance the concepting and technology of the next-generation combat aircraft to 2025.

On the Global Combat Air Programme, a trilateral collaboration agreement between BAE Systems, Leonardo SpA (Italy) and Mitsubishi Heavy Industries (Japan) is now in place to enable collaboration and sharing of information towards the next phase of activities.

The Company secured a further £535m of funding for European Common Radar System (ECRS) Mk2 Radar development for the Typhoon weapon system. The Royal Air Force of Oman has elected not to renew the current support arrangements for its Typhoon fleet. Discussions around the Company's role in providing a level of support to the Royal Air Force of Oman continue.

The Company secured the Lightning Air System National Capability Enterprise (LANCE) contract in March 2023, which extends the Company's leadership of UK F-35 support at RAF Marham until the end of 2027.

Following the completion of the previous five-year Salam Typhoon support contract on 31 December 2022, the Company reached an agreement with the Saudi Arabian Government to continue to provide these services for another five years through to the end of 2027, valued at £3.7bn.

Strategic Report (continued)
for the year ended 31 December 2023

Review of business (continued)

Strategic and order highlights (continued)

Through FalconWorks®, the Air sector continues to invest in promising new and innovative technologies for the future, including the development of electric aircraft products with a number of partners.

Key performance indicators

Key financial performance indicators are shown below:

	2023	2022
	£m	£m
Order intake	8,026	11,767
Revenue	6,785	6,473
Operating profit	538	597

Order intake represents funded orders received from customers in the year. Significant orders include agreement of a further five-year Salam Typhoon support contract, valued at £3.7bn.

Revenue represents the income derived from the provision of goods and services. The increase in revenue is driven by higher air support volumes, while the future combat air programme continues to gain pace with activity more than doubling in 2023.

Operating profit represents profit for the year before income from subsidiary undertakings and participating interests, net finance costs and taxation expense. The steady operating profit level reflects good operational performance, with the prior year benefiting from some one-off gains on the settlement of historically provided for aged receivables.

Principal risks and uncertainties

The Company's principal risks are identified below, along with their potential impact on the Company and how these are currently being managed:

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. Levels of defence spending by governments are difficult to predict and can fluctuate depending on changes in government policy, other political considerations, budgetary constraints, specific threats to national security and macro-economic conditions (including movements in oil prices). From time to time, there have been constraints on government expenditure in a number of the Company's principal markets.

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

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. Many of the countries in which the Company operates have announced increases or are making plans to increase spending to address the elevated threat environment. Whilst governments face global economic and fiscal pressures, the commitment to defence in the Company's major markets remains robust. The Company's principal markets – the UK and the Kingdom of Saudi Arabia – have a significant and sustained commitment to defence and security. The Company benefits from a large order backlog, with established positions on long-term programmes in its principal markets. The Company also has a portfolio of commercial businesses.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

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 (continued).

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 Kingdom of 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. Furthermore, governments 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. Further, 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 business, results of operations, financial condition and prospects.

Mitigation: The Company has established strong and enduring relationships in its principal markets and is recognised as playing a key role in the industrial capability of each of the countries in which it operates. 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 receipt and timing of the award of defence contracts and the profile of cash receipts thereunder.

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. This in turn could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

Mitigation: The Company monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet its operational needs and maintain adequate headroom.

Contract risk, execution and supply chain.

Contract risk and execution

Description: The Company executes long-term high-value contracts for the provision of complex, strategically important products and services for its customers. A significant portion of the Company's revenue is derived from fixed-price contracts. Actual costs incurred may exceed the projected costs, including assumptions on future rates of inflation, on which the fixed prices are agreed may prove to be inaccurate 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 delivers on its projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

Contract risk, execution and supply chain (continued).

Contract risk and execution (continued)

Impact: The failure by the Company to anticipate technical problems or deliver on its contractual commitments could result in (among other things) the loss, expiration, suspension, cancellation or termination of any one of its large contracts, which could have a material adverse effect on the Company's business, results of operations, financial condition, prospects or reputation. The failure to estimate accurately and control costs on fixed-price contracts could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

Mitigation: All of the Company's major programmes are managed under the BAE Systems Group's mandated Lifecycle Management process, which includes contract-related risks. 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. The Company has limited exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. Further, the Company has a well-balanced spread of programmes and a significant defence order backlog which provides portfolio resiliency and forward visibility. A significant proportion of the Company's largest and most complex 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. A leadership development programme for project directors is in place across the Company, covering the leadership competencies required to manage complex projects containing significant levels of risk and uncertainty.

Supply chain

Description: The Company is dependent upon the delivery of services and 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. This can be exacerbated where the Company is dependent on either one or a limited number of suppliers. Some of the Company's suppliers or subcontractors may be impacted by the economic environment (including inflationary pressures and material shortages) which could impair their ability to meet their obligations to the Company and to supply on satisfactory commercial terms.

Impact: A failure by one or more of the Company's suppliers to provide the agreed-upon materials, components or products or perform the agreed-upon services, on a timely basis, at the agreed price, according to specifications (including compliance with regulatory requirements) or at all may adversely affect the Company's ability to perform its obligations, result in additional costs or delays, require the Company to transition work to other companies (resulting in further additional costs and delay) and/or result in penalties under, or the termination of, customer contracts. This impact is heightened where a supplier is a sole supplier or one of a small number of suppliers. Additionally, the Company could be adversely affected by actions, or issues experienced by, the Company's suppliers which are outside its control, such as misconduct and reputational issues involving the Company's suppliers, which could subject the Company to liability or adversely affect its ability to compete for contracts. Any of the foregoing could have a material adverse effect on the Company's business, results of operations, financial condition, prospects and reputation.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

Contract risk, execution and supply chain (continued).

Supply chain (continued)

Mitigation: The Company's supply chain function establishes and manages enduring end-to-end integrated supplier arrangements, in partnership with the programmes it supports. 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 better manage supplier deliverables against programme requirements. Supply chain management starts with the BAE Systems Group's Global Procurement Policy which defines the requirements to be implemented by each of its sectors for the establishment of procurement controls and the management of supplier-related risk. Risk-based due diligence and audit activity is undertaken for each supplier whom the Company engages. Once a supplier has been approved, and a contract has been executed, the supply chain function continues to monitor that supplier. The supply chain risk management programme is working toward providing an enterprise-wide view of supplier risk, contributing to the continuity of supply and enabling better intelligence of sub-tier supply chain risk. Regular global supply chain meetings are held with senior procurement leaders to ensure that the latest risk data is appropriately shared. The Company seeks to manage inflation risk through its customer contracting arrangements on many of its major programmes, supplier cost management activity and through its long-term supplier agreements.

The Company operates in international markets.

Political

Description: International sales and operations are sensitive to: social and political changes impacting the business environment; economic downturns and inflation; political instability, armed conflict and civil disturbances; the imposition of capital controls; the introduction of burdensome taxes or tariffs; changes to export control, tax 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 and other trade restrictions. For example, the risk of the Company's inability to obtain and maintain the necessary export licences for the Company's business in the Kingdom of Saudi Arabia could affect the Company's provision of capability to that country.

Impact: Any of these factors could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

Mitigation: The Company has a balanced portfolio of businesses across a number of markets internationally. The Company benefits from a large order backlog, with established positions on long-term programmes in the UK and the Kingdom of Saudi Arabia. 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. Whilst some of the Company's contracts are on a government-to-government basis, for contracts which are not government-to-government, political risk insurance is held where considered appropriate with regard to the level of risk involved. However, as with all insurance, it does not provide full cover against all potential loss scenarios. The Company has a well-established legal and regulatory compliance structure aimed at ensuring adherence to legal and regulatory requirements and identifying restrictions that could adversely impact the Company's activities, including export control requirements.

Currency

Description: Given the international nature of its business, the Company is exposed to volatility arising from movements in currency exchange rates, particularly in respect of the US dollar, euro and Saudi riyal.

Impact: Significant fluctuations in exchange rates to which the Company is exposed could cause volatility in its financial results reported in pounds sterling and could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

The Company operates in international markets (continued).

Currency (continued)

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

Competitive markets

Description: The international markets in which the Company operates are highly competitive and the Company's business depends upon its ability to win and contract for high-quality new programmes in these markets. The Company is dependent upon UK Government support in relation to a number of its business opportunities in export markets. Furthermore, the Company's competitors may also develop new technologies or offerings, novel support models or more efficient ways to produce existing products that could cause the Company's existing products or services to become obsolete or that could gain market acceptance before the Company's own products or services.

Impact: If the Company is unable to compete adequately and/or obtain new business in the international markets in which it operates, there may be a material adverse effect on its business, results of operations, financial condition and prospects.

Mitigation: The Company has an international, multi-market presence, a broad portfolio of products and services, 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, support for promotional activities and financial support through UK Export Finance.

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

Cyber Security

Description: As a major defence, aerospace and security company, it is critical that the Company's information technology and operational technology (IT & OT) infrastructure, as well as the products and services it sells, are cyber resilient and the proprietary, classified, confidential or otherwise protected information, intellectual property and personal data held and processed on them are appropriately secured. Cyber security threats are continuous and evolving, and vary from attacks common to most industries, including those originating both externally and internally, to those from more advanced and persistent, highly organised adversaries, including nation states. The war in Ukraine has also increased Russian-aligned hacktivist activity against pro-Ukraine nations and their defence industries. The cyber security threats faced by the Company include (but are not limited to): an attack impacting the availability of the Company's IT & OT infrastructure and systems and/or those of its customers, partners and suppliers; unlawful attempts to gain access to the Company's proprietary, classified, confidential or otherwise protected information, intellectual property and personal data, and that held or generated by the Company on behalf of its customers, partners and suppliers; and compromise of products and services for the purposes of sabotage or to disable or deny their use and/or alter their performance characteristics. The Company might also be exposed to cyber security risks through an attack on the Company's supply chain.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

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

Cyber Security (continued)

Impact: Given the nature and scope of cyber attacks, it is possible that the Company is unable to defend itself against all cyber-attacks, that unknown vulnerabilities could be exploited or that the Company may otherwise be unable to mitigate customer losses and other potential liabilities (including potential liabilities related to privacy and intellectual property). The Company could potentially be subject to: (a) production downtimes; (b) operational delays; (c) other detrimental impacts to its operations or ability to provide products and services to customers; (d) the compromise, misappropriation, destruction or corruption of the Company's proprietary, classified, confidential or otherwise protected information, intellectual property and personal data, and that held or generated by the Company on behalf of its customers, partners and suppliers; (e) security breaches; (f) other manipulation or improper use of the Company's or third-party systems, networks or products; and/or (g) financial losses from remedial actions, loss of business, or potential liability, penalties, fines and/or damages. Any of these could have a material adverse effect on the Company's business, results of operations, financial condition, prospects and reputation.

Mitigation: The security of the BAE Systems Group's products and services, data, facilities and IT & OT infrastructure is regularly considered by the BAE Systems Group's Board and senior management and underpins the BAE Systems Group's strategy and influences its engineering, technology and digital strategies. Education and awareness to embed a strong cyber security culture across the Company is another vital part of its preventative activities. Employees are subject to mandatory training which, depending on role, covers cyber security, physical security, document marking, security of export-controlled information, and personal data protection. As many cyber-attacks involve email, the Company runs a programme of phishing exercises for all email users across the enterprise. To further increase cyber resilience, the BAE Systems Group's Security Operations Centres perform continual protective monitoring of activity on core networks. The Cyber Incident Response plan feeds into the BAE Systems Group's crisis management plan and regular exercises are conducted across the business to test the Cyber Incident Response plan, including up to the BAE Systems Group's Executive Committee. The BAE Systems Group purchases cyber insurance; however, as with all insurance, it does not provide full cover against all potential loss scenarios. To mitigate the cyber security risk posed by suppliers, the Company includes cyber security-related obligations in its contracts where relevant. Cyber security risk is constantly reviewed and an agile, proactive, approach to mitigating the risk is taken. The BAE Systems Group does this by efficiently leveraging its core internal capabilities in cyber security, including its specialist threat intelligence service, to maintain a managed risk position as it digitally transforms and the threat landscape evolves.

Employees work with hazardous materials and in challenging locations and the Group's products and services, and those of its customers' or suppliers', inherently pose a safety risk.

Activities

Description: Given the nature of the Company's business, employees work in challenging locations, perform potentially hazardous activities and at times use hazardous materials. The hazards associated with the Company's activities and working environments can cause harm to its people and those affected by its operations unless the risk of those hazards occurring has been appropriately reduced.

Impact: There could be significant impacts if the Company fails to meet the necessary standards to adequately mitigate against health and safety risks. The Company may face criminal and civil prosecution in connection with health and safety incidents, which could result in substantial penalties and fines. Furthermore, the Company could be prevented from operating, due to employees being unavailable for work, investigations being conducted or if a regulatory approval or certification is withdrawn, potentially leading to contractual penalties due to loss of productivity or inability to deliver on contractual commitments. Any of these factors could have a material adverse effect on the Company's business, results of operations, financial condition, prospects and reputation.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

Employees work with hazardous materials and in challenging locations and the Group's products and services, and those of its customers' or suppliers', inherently pose a safety risk (continued).

Activities (continued)

Mitigation: Safety of the BAE Systems Group's personnel, contractor personnel and the wider communities in which the BAE Systems Group operates is a primary concern. The BAE Systems Group monitors its safety performance constantly through leading and lagging indicators and strives to be a leader in safety performance. Safety performance is led at the BAE Systems Group Executive Committee level by the ESG, Culture and Business Transformation director and is reported to the BAE Systems plc Board quarterly (with the BAE Systems plc Chief Executive providing updates at each Board meeting). Accountability for safety performance at a business level rests with the relevant managing director, who is responsible for ensuring compliance with the BAE Systems Group's Safety, Health and Environmental management systems and the BAE Systems Group's Operational Framework (the "Operational Framework"). At a user level, every employee receives safety training that is both company-wide and job role-specific. The Company follows recognised safety risk assessment processes that are task specific and seeks to ensure hazards are identified, classified and mitigated against prior to activities taking place. The Company's safety performance and practices are assured both internally and by external consultants to ensure compliance with both BAE Systems Group and regulatory standards.

Products and services

Description: The Company designs, develops, manufactures and maintains highly complex and specialised products and services. By their very nature, many of the Company's products and services are hazardous and technical, mechanical and other failures may occur from time to time, whether as a result of a manufacturing or design defect, ineffective maintenance, incorrect usage, poorly executed integration with a third party's products or services or through some other cause. In addition, the safety of the Company's products could be compromised as a result of cyber-attacks, such as those that seize control and result in misuse or unintended use of the Company's products, or other intentional acts.

Impact: The impact of a catastrophic product, service or system failure or similar safety incident affecting the Company's, its customers' or its suppliers' products or services could be significant and could result in injuries or death, property damage, loss of strategic capabilities, loss of intellectual property, environmental harm, reputational damage or other significant effects. It could also lead to a loss of equipment, product recalls and product liability and warranty claims, other service, repair and maintenance costs, significant damages and other costs (including fines and other remedies), regulatory and environmental liabilities and a reduction in demand for the Company's products and services. Any of the foregoing could have a material adverse effect on the Company's business, results of operations, financial condition, prospects and reputation.

Mitigation: The Company recognises it is vitally important to work with its customers, suppliers and partners to ensure its products continue to work safely, securely and with integrity, within their intended operational environments. The Company ensures the safe design and development of its products through a system of controls centred on its Operational Framework and associated policies and procedures, including those specifically addressing Product Safety and Engineering standards. Assurance of adherence to these aspects of the Operational Framework is provided through regular operating business review, reporting and assessment, with independent assessment of the effectiveness of controls by in-house subject matter experts, BAE Systems Group Internal Audit and external domain regulators. In addition to the above, the Company continues to evolve and improve product safety best practice driven by new technologies and ways of working; liaise across industry and its government customers to develop new safety-related standards; and learn from safety-related failures in adjacent industries.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

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

Description: Competition for the people the Company needs to deliver its strategy, including those with innovative technological capabilities, is high. Competition may be intensified by nationality and regulatory restrictions (including the requirement for security clearances for certain roles), and exacerbated by macroeconomic, industry and labour market conditions more generally.

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 its business plan and deliver on its contractual commitments, which accordingly could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

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, 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.

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

Description: A funding deficit could be caused by a number of factors including insufficient investment returns and greater than expected member longevity.

Impact: If a funding deficit were to arise, the Company may be required to make deficit repair contributions to those schemes, thereby reducing cash available to meet the Company's other capital allocation priorities. This could have a material adverse effect on the Company's business, results of operations, financial condition and prospects.

Mitigation: The funding positions of the schemes are monitored on a regular basis and the latest triennial actuarial valuations of the Company's UK defined benefit pension schemes showed as at their respective dates that there is no funding deficit in any of those schemes on a technical provisions basis. That position is estimated to have been maintained since then. Each defined benefit scheme pursues an investment strategy designed to provide a high probability that the scheme will be able to satisfy its liabilities as they fall due, even under a range of plausible downside scenarios. To further reduce the risk of deficits arising in the future, the schemes' Trustees, in conjunction with the Company, have continued to take action to hedge major risk factors such as inflation and interest rate risk, and longevity risk. All of the Company's UK defined benefit schemes have been closed to new employees since 2012.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

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

Description: The Company is subject to comprehensive environmental laws, regulations and permitting requirements 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. Increasingly, environmental legislation is seeking to encourage a reduction in greenhouse gas (GHG) emissions. These laws, regulations and/or permitting requirements may be interpreted in different ways, conflict and/or change from time to time (as may any related interpretations and guidance). 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. In addition, the Company may 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 (a) the Company's ability to attract and retain future talent; (b) the technology evolution and innovation required to respond to future customer lower-emissions requirements; (c) energy-related taxes; and (d) the increased costs of compliance with energy-related schemes.

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 unplanned capital and operating costs associated with compliance, remediation and protection of the environment. Breaches of these 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 as those of its 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 BAE Systems Group has set itself the target of achieving net zero GHG emissions across its operations (Scope 1 and 2) by 2030 and working towards a net zero value chain by 2050 and has developed a plan to deliver this goal which includes exploring green energy options and surveying its buildings to determine how to make them more energy efficient. During 2023, the BAE Systems Group further developed its understanding of climate-related risks and opportunities in order to better understand potential unmitigated risks and its business readiness to mitigate any such risks. The Company uses analytical tools to apply natural catastrophe classifications to its sites worldwide. This has informed its strategy as to where to target a programme of specific flood, windstorm and earthquake assessments of the Company's sites and implement the subsequent risk reduction recommendations. The BAE Systems Group maintains property insurance cover which includes property damage and business interruption; however, as with all insurance, it does not provide full cover against all potential loss scenarios. The Company continues to progress a programme of work to understand the GHG emissions profile of its material products. This work will help the Company understand how to further progress efficiency of the Company's products; to research and develop alternate solutions; and to identify how the Company can support future customer decisions and investment in product upgrades and new product development, having due regard for environmental considerations.

Strategic Report (continued)
for the year ended 31 December 2023

Principal risks and uncertainties (continued)

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 therefore subject to a variety of legal, regulatory and litigation risks. These risks relate to (among other things) trade controls, intellectual property rights, data protection and security, contract-related claims, government contracts (including audits and reviews of those contracts), taxes, environmental matters, sanctions, product safety and reliability, health and safety, employment matters, competition laws and laws governing improper business practices (such as money laundering, false accounting, anti-bribery and corruption, and anti-boycott laws). These laws and regulations may be interpreted in different ways, conflict and/or change from time to time (as may any related interpretations and guidance). For example, 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: Changes in laws and regulations (or the interpretation thereof) could result in higher compliance costs and impact customer or supplier contracts. Uncertainty relating to laws and regulations may also affect how the Company conducts its business and could limit its ability to enforce its rights. A breach of applicable legislation and/or regulations by the Company, its employees, sales representatives, marketing advisers or others working on its behalf could result in significant fines, penalties or other damages and/or the suspension or debarment of the Company from government contracts or the suspension of the Company's export privileges. If customers or other third parties were harmed by the conduct of members of the Company, this may also give rise to legal proceedings, including class actions. Other legal disputes may also arise between members of the Company and third parties relating to matters such as breaches or enforcement of legal rights or obligations arising under contracts, statutes or common law. Adverse findings in any such matters may result in members of the Company being liable to third parties or may result in rights not being enforced or not being enforced in the manner intended or desired. Any of the foregoing could have a material adverse effect on the Company's business, results of operations, financial condition, prospects and reputation.

Mitigation: The BAE Systems Group 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 and an export control policy mandates compliance with all applicable trade controls requirements. It is important that the Company maintains a culture in which it focuses on responsible business behaviours and that all employees act in accordance with the requirements of the BAE Systems Group's policies, including the Code of Conduct, at all times. Accordingly, it continues to reinforce the BAE Systems Group's ethics programme globally, supporting employees in making ethical decisions and embedding responsible business practices. The Company's internal legal team and, where appropriate, external counsel manage litigation and advise on the management of associated impacts.

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.

Strategic Report (continued)
for the year ended 31 December 2023

Section 172(1) statement (continued)

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

The safety, wellbeing, skills, capabilities and commitment of the Company's people are critical to ensuring the long-term sustainability of the Company's business and delivering the innovation needed to solve the Company's customers' complex challenges.

Effective engagement enables our employees to contribute to improving business performance and helps the Company to create an environment in which everyone is safe, valued and can fulfil their potential.

The Company used a range of channels to engage with employees 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 surveys and insight sessions; in-person and virtual meetings, briefings, conferences, events and listening forums at all levels; regular leadership updates through videos and events throughout the year (including in relation to financial and business performance); and engagement through the BAE Systems Group's Employee App, intranet, email and TV systems.

The Company operates an Employee Incentive Scheme which entitles all employees to a financial benefit against the achievement of a set of business and programme milestones. This ensures that all employees feel connected with, and are invested in, the Company's achievements.

These engagement activities form part of the Company's implementation of the BAE Systems group-wide employee engagement processes and policies which are described on pages 24 and 56 of BAE Systems plc's 2023 Annual Report (available at: www.baesystems.com/investors).

Pursuant to the BAE Systems Group's People Policy, directors and employees are required to contribute to creating an engaged and inclusive working 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)
for the year ended 31 December 2023

Section 172(1) statement (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, 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, Kingdom of Saudi Arabia and Qatar.

The Company, through its 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 meetings are held with key suppliers to foster deeper relationships with businesses in the supply chain and develop strategic relationships with key suppliers. The Group's supply chain function continues to actively manage supply lead times against demand requirements.

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. The Company implements the requirements of the BAE Systems Group's Community Investment Policy, which is mandated through the Operational Framework and 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 and Warton Enterprise Zones with the aim of creating hubs for aerospace, technology and innovation. In the Kingdom of 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 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 on pages 48 to 55 of BAE Systems plc's 2023 Annual Report (available at: www.baesystems.com/investors).

Strategic Report (continued)
for the year ended 31 December 2023

Section 172(1) statement (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 is described on pages 62 to 65 in BAE Systems plc's 2023 Annual Report (available at: www.annualreport.baesystems.com/2023).

Approved by the Board and signed on its behalf by:



Director

MR G.J. EDWARDS

Date: 25 July 2024

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 £670m (2022: £538m profit). The directors propose a dividend of £660m (2022: £530m).

The dividend proposed per share is £0.66 (2022: £0.53).

Looking forward

The UK Future Combat Air System is a key element of the UK Combat Air Strategy which enables long-term planning and investment in a key strategic part of the business, ensuring the business has a long-term combat aircraft design, development and manufacturing capability.

The Company will continue to focus on ensuring that deliveries of Typhoon aircraft and support are made in line with agreed customer milestones. Future Typhoon production and support sales are underpinned by existing contracts and discussions continue to secure potential further contract awards for Typhoon.

Production of the rear fuselage assemblies for the F-35 has reached full rate levels and is expected to be sustained at approximately 150 to 160 aft fuselages to be completed annually. The business plays a significant role in the F-35 sustainment programme in support of Lockheed Martin and support volumes should increase as the number of jets in service continues to increase.

In the Kingdom of Saudi Arabia, the In-Kingdom Industrial Participation programme continues to make good progress consistent with our long-term strategy, whilst supporting the Kingdom's National Transformation Plan and Vision 2030. The Company's in-Kingdom support business is expected to remain stable, underpinned by long-standing contracts that are expected to be renewed every five years, while the Company will continue to support development of a Future Combat Air Partnership between the Kingdom of Saudi Arabia and the UK.

Post Balance Sheet events

At 31 December 2023, BAE Systems (Kazakhstan) Limited, a subsidiary of the Company, held a 49% shareholding in Air Astana.

On 12 January 2024, Air Astana announced its intention to proceed with a joint initial public offering (IPO) on the London Stock Exchange, the Astana International Exchange in Kazakhstan, and the Kazakhstan Stock Exchange. On 9 February 2024, the IPO was launched. As a result of the IPO, the Company's indirect shareholding in Air Astana has reduced from 49% to 16.95% as at the date of this report.

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 has net assets of £4,060m, made a profit of £670m and order intake continues to be positive.

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.

Directors' Report (continued)

Overseas branch 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.

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 and invests in next-generation research and technology programmes to improve the manufacturing and service of products, generating substantial intellectual property. Total research and development expenditure in the year was £1,101m (2022: £752m), of which £242m (2022: £192m) was funded by the Company.

Energy and Carbon Reporting exemption

The Company has taken advantage of the exemption granted under The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 as this information is disclosed on pages 232 to 235 of BAE Systems plc's 2023 Annual Report (available at www.annualreport.baesystems.com/2023).

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 Alvis 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 Alvis 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 within the Strategic Report on page 12.

Financial risk

The applicable financial risk management policies and exposure to financial risks including price, credit, liquidity and cash flow risks are discussed in detail within the BAE Systems plc Group accounts.

Directors' Report (continued)

Corporate governance statement

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

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

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

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

Purpose, strategy, values and culture

The BAE Systems Group has a strategic framework that sets out the Group's vision, mission and strategy and sets out three strategic priorities which are embedded throughout each business in the Group. This provides the link between the Group's long-term strategy and the near-term business objectives for all employees in the Company. The Company produces 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 employees in doing the right thing. All employees in the Company receive annual training designed to stimulate conversations about ethical decision making.

Board and directors' accountability

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

Those requirements ensure that internal controls are in place and documented and 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.

Directors' Report (continued)

Corporate governance statement (continued)

Board and directors' accountability (continued)

As part of a robust system of internal controls, the authority of the managing directors of the businesses of the Company are 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 businesses lies with the managing directors of the businesses for which they are responsible. They are also responsible for reporting and monitoring key risks in accordance with established processes under the BAE Systems Group's Operational Framework.

The BAE Systems Group's risk management process is set out in the Risk Management Policy, a mandated policy under the Operational Framework, and, in respect of projects, in the Lifecycle Management Framework, a core business process under the Operational Framework. The Lifecycle Management Policy sets out how the Company must plan and manage the execution of projects above a certain minimum level, providing decision gate reviews at key stages from initial opportunity to final closure.

Further guidance is provided by a Risk Management Maturity self-assessment tool. Identified risks are documented in risk registers showing: the risks that have been identified; characteristics of the risk; the basis for determining mitigation strategy; and what reviews and monitoring are necessary. Each risk is allocated an owner who has authority and responsibility for assessing and managing it.

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

Remuneration

The BAE Systems Group's Performance Leadership framework is a core business process designed to support the development of a diverse and inclusive culture that delivers the group's strategy. The framework provides a principled approach to performance, assessment, development and reward for employees and is required to be implemented within the businesses of the Company. The BAE Systems plc Remuneration Committee is responsible for reviewing the BAE Systems Group's workforce remuneration and related policies and the alignment of incentives and rewards with culture, and take these into account when setting the policy for executive remuneration.

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. The policy also requires employees 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 and to support them by managing risks throughout the lifecycle of any commercial arrangement. The businesses manage risk with their suppliers in accordance with the BAE Systems Group's Procurement Policy, Lifecycle Management Framework and Supplier Principles. The 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)

Stakeholders (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.

Climate-related financial disclosures

The Company has taken advantage of the exemption granted under The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022 as this information is disclosed on pages 48 to 55 of BAE Systems plc's 2023 Annual Report (available at www.baesystems.com/investors).

Directors and their interests

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

Mr P S Inman	(resigned 28 February 2023)
Mr C M Robson	(resigned 31 December 2023)
Ms A J Thompson	(resigned 31 December 2023)
Mr S R Barnes	(appointed 11 March 2024)
Mrs S Addison	(appointed 01 January 2023)
Mr G J Edwards	(appointed 01 March 2023)
Mr H L M Claesen	(appointed 17 March 2023)

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.

Directors' Report (continued)

Approved by the Board and signed on its behalf by:



Mr G J Edwards
Director

Date: 25 July 2024

Registered office:
BAE Systems (Operations) Limited
Victory Point
Lyon Way
Frimley
Camberley
Surrey
GU16 7EX
England
United Kingdom

Directors' Responsibilities Statement

The directors are responsible for preparing the Annual 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 accounting 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 2023 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 30.

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; and
- 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.

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

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.

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 and the directors about their own identification and assessment of the risks of irregularities, including those that are specific to the company's business sector.

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

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. This included UK Companies Act, pensions 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. This included 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.

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, internal audit and legal counsel 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.

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

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.

Claire Faulkner

Claire Faulkner (Senior statutory auditor)

For and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom

Date: 25 July 2024

Income Statement
for the year ended 31 December 2023

	Note	2023 £m	2022 £m
Revenue	3	6,785	6,473
Operating costs	4	(6,325)	(5,949)
Other income	5	78	73
Operating profit		538	597
Financial income	6	173	58
Financial expense	7	(10)	(33)
Dividends from investments		6	-
Profit before tax		707	622
Tax	10	(37)	(84)
Profit for the financial year		670	538

Statement of Comprehensive Income
for the year ended 31 December 2023

	Note	2023 £m	2022 £m
Profit for the financial year		670	538
Other comprehensive (expense)/income:			
Items that will not be reclassified to profit or loss:			
Remeasurements on post-employment benefit schemes	23	(358)	1,711
Tax on items that will not be reclassified to the Income Statement	10	(3)	(251)
Items that may be reclassified to the Income Statement:			
Fair value gain/(loss) arising on hedging instruments during the year	25	49	(96)
Cumulative fair value (gain)/loss on hedging instruments reclassified to the income statement	25	(2)	21
Tax on items that may be reclassified to the Income Statement		(12)	19
Other comprehensive (expense)/income net of tax		(326)	1,404
Total comprehensive income for the year		344	1,942

There were no recognised gains and losses for 2023 or 2022 other than those included in the income statement.

The notes on pages 31 to 78 form part of these financial statements.

The results for 2023 and 2022 arose from continuing activities.

Balance Sheet
as at 31 December 2023

	Note	2023 £m	2022 £m
Non-current assets			
Intangible assets	11	99	90
Property, plant and equipment	12	433	420
Right-of-use assets	13	168	156
Investment property	14	45	51
Investments in subsidiary undertakings and participating interests	15	1	1
Other receivables	16	7,977	7,020
Retirement benefit surpluses	23	432	660
Other financial assets	17	84	101
Deferred tax assets	18	21	92
		9,260	8,591
Current assets			
Inventories	19	233	177
Trade, contract and other receivables	16	2,581	2,682
Other financial assets	17	102	146
Current tax	20	167	105
Cash and cash equivalents		17	10
		3,100	3,120
Total assets		12,360	11,711

Balance Sheet (continued)
as at 31 December 2023

	Note	2023 £m	2022 £m
Non-current liabilities			
Lease liabilities	13	(220)	(214)
Contract liabilities	21	(1,062)	(242)
Other payables	22	(24)	(23)
Post-employment benefit obligations	23	(51)	(49)
Other financial liabilities	17	(90)	(177)
Provisions	24	(20)	(15)
		(1,467)	(720)
Current liabilities			
Lease liabilities	13	(22)	(19)
Contract liabilities	21	(2,518)	(2,711)
Trade and other payables	22	(4,116)	(3,857)
Other financial liabilities	17	(123)	(164)
Provisions	24	(54)	(24)
		(6,833)	(6,775)
Total liabilities		(8,300)	(7,495)
Net assets		4,060	4,216
Capital and reserves			
Issued share capital	25	1,008	1,008
Share premium		25	25
Other reserves	25	(26)	(65)
Retained earnings		3,053	3,248
Total equity		4,060	4,216

Approved by the Board on 25 July 2024 and signed on its behalf by:



Mr G J Edwards
Director

Registered number: 01996687

Statement of Changes in Equity
for the year ended 31 December 2023

	Issued share capital £m	Share premium account £m	Other reserves £m	Retained earnings £m	Total equity £m
At 1 January 2022	1,008	25	17	1,543	2,593
Profit for the year	-	-	-	538	538
Other comprehensive (expense)/income	-	-	(56)	1,460	1,404
Total comprehensive (expense)/income for the year	<u>-</u>	<u>-</u>	<u>(56)</u>	<u>1,998</u>	<u>1,942</u>
Dividends (note 26)	-	-	-	(315)	(315)
Share-based payments	-	-	-	22	22
Cumulative fair value gain on hedging instruments transferred to the Balance Sheet (net of tax)	-	-	(26)	-	(26)
At 31 December 2022	<u>1,008</u>	<u>25</u>	<u>(65)</u>	<u>3,248</u>	<u>4,216</u>
Profit for the year	-	-	-	670	670
Other comprehensive (expense)/income	-	-	35	(361)	(326)
Total comprehensive income for the year	<u>-</u>	<u>-</u>	<u>35</u>	<u>309</u>	<u>344</u>
Dividends (note 26)	-	-	-	(530)	(530)
Share-based payments	-	-	-	26	26
Cumulative fair value loss on hedging instruments transferred to the Balance Sheet (net of tax)	-	-	4	-	4
At 31 December 2023	<u><u>1,008</u></u>	<u><u>25</u></u>	<u><u>(26)</u></u>	<u><u>3,053</u></u>	<u><u>4,060</u></u>

The notes on pages 31 to 78 form part of these financial statements.

Notes to the Financial Statements

1. General information

BAE Systems (Operations) Limited is a private company, limited by shares, and registered in England and Wales and incorporated in the United Kingdom. Its ultimate controlling party is disclosed in note 30. The address of the Company's registered office is shown on page 20.

The principal activity of the Company is set out in the Strategic Report on page 1. These financial statements, which have been prepared in accordance with the Companies Act 2006, are presented in pounds sterling (the Company'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 2.12.

2. Accounting policies

2.1 Basis of preparation

These financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 101 "Reduced Disclosure Framework". 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), and in accordance with the Companies Act 2006. Advantage has been taken of the FRS 101 disclosure exemptions as set out below:

- 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 91-99 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 paragraph 52, the second sentence of paragraph 89, and paragraphs 90, 91 and 93 of IFRS 16 Leases. The requirements of paragraph 58 of IFRS 16, provided that the disclosure of details in indebtedness relating to amounts payable after 5 years required by company law is presented separately for lease liabilities and other liabilities, and in total;
- 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 Presentation of Financial Statements;
 - 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 paragraph 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

Notes to the Financial Statements

2. Accounting policies (continued)

2.1 Basis of preparation (continued)

- the requirements of paragraphs 130(f)(ii), 130(f)(iii), 134(d)-134(f) and 135(c)-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.

These financial statements have been prepared using the going concern basis of accounting. As discussed in the Director's Report (page 15).

Notes to the Financial Statements

2. Accounting policies (continued)

2.1 Basis of preparation (continued)

Key sources of estimation uncertainty

The application of the Company's accounting policies requires the use of estimates. 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:

<u>Accounting policy</u>	<u>Description</u>
Revenue and profit recognition	<p>The Company accounts for revenue in accordance with IFRS 15 Revenue from Contracts with Customers. For most of the Company's contracts, revenue and associated margin are recognised progressively over time as costs are incurred, and as risks have been mitigated or retired. 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. 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 health and safety, 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. Material changes in these estimates could affect the profitability of individual contracts.</p>

As shown in note 3, the Company has recognised £0.1bn of revenue in respect of performance obligations satisfied or partially satisfied in previous periods (2022 £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

2. Accounting policies (continued)

2.1 Basis of preparation (continued)

Valuation of retirement benefit obligations

A number of actuarial assumptions are made in assessing the value of post-employment benefit obligations, including the 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, 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 macroeconomic issues. The impact of estimates made with regard to mortality projections may also change.

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 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.

Furthermore, estimates are required around the Group's ability to access its defined benefit surpluses, and on what basis, which then determines the associated rate of tax to apply. Depending on the outcome, judgment is then required to determine the presentation of any tax payable in recovering the surplus.

Note 23 provides information on the key assumptions and analysis of their sensitivities.

Notes to the Financial Statements

2. Accounting policies (continued)

2.1 Basis of preparation (continued)

Critical accounting judgments

In the course of preparing the financial statements, no judgements have been made in the process of applying the Company's accounting policies, other than those involving estimates, that have had a significant effect on the amounts recognised in the financial statements.

Changes in accounting policies

The following standards, interpretations and amendments to existing standards became effective on 1 January 2023 and have not had a material impact on the Company:

- IFRS 17 Insurance Contracts, effective from 1 January 2023;
- Amendments to IAS 1: Presentation of Financial Statements, effective from 1 January 2023;
- Amendments to IFRS Practice Statement 2: Disclosure of Accounting Policies, effective from 1 January 2023;
- Amendments to IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors, effective from 1 January 2023; and
- Amendments to IAS 12: Income Taxes, effective from 1 January 2023.

The following other standards, interpretations and amendments to existing standards have been issued but were not mandatory for accounting periods beginning on 1 January 2023. These either have been, or are expected to be endorsed by the UK Endorsement Board and are not expected to have a material impact on the Company:

- Amendments to IAS 1: Classification of Liabilities as Current or Non-current, effective from 1 January 2024;
- Amendments to IAS 1: Non-Current Liabilities with Covenants, effective from 1 January 2024;
- Amendments to IAS 7 and IFRS 7: Supplier Finance Arrangements, effective from 1 January 2024;
- Amendments to IFRS 10 and IAS 28: Sale or Contribution of Assets between an Investor and its Associate or Joint Venture;
- Amendments to IFRS 16: Lease Liability in a Sale and Leaseback, effective from 1 January 2024; and
- IFRS 18 Presentation and Disclosure in Financial Statements, effective from 1 January 2027.

Material accounting policies

The material 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.

2.2 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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.2 Revenue and profit recognition (continued)

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.

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. As they are not provided separately, these are not considered to be insurance contracts in scope of IFRS 17 Insurance Contracts. A provision is recognised when the underlying products and services are sold (see note 24 for further details).

Transaction price

At the start of the contract, the total transaction price is estimated as the amount of consideration to which the Company expects to be entitled in exchange for transferring the promised goods and services to the customer, excluding sales taxes. Variable consideration, such as price escalation, is included based on the expected value or most likely amount only to the extent that it is highly probable that there will not be a reversal in the amount of cumulative revenue recognised. The transaction price does not include estimates of consideration resulting from contract modifications, such as change orders, until they have been approved by the parties to the contract. The total transaction price is allocated to the performance obligations identified in the contract in proportion to their relative stand-alone selling prices. Given the bespoke nature of many of the Company's products and services, which are designed and/or manufactured under contract to the customer's individual specifications, there are typically no observable stand-alone selling prices. Instead, stand-alone selling prices are typically estimated based on expected costs plus contract margin consistent with the Company's pricing principles.

Whilst payment terms vary from contract to contract, on many of the Company's contracts, an element of the transaction price is received in advance of delivery. The Company therefore has significant contract liabilities. The Company's contracts are not considered to include significant financing components on the basis that there is minimal difference between the consideration and the cash selling price either as a result of UK Ministry of Defence contracting rules which prohibit the inclusion of financing in the sales price or negotiations on competitive international export contracts which do not make allowance for the cash payment profile.

Notes to the Financial Statements

2. Accounting policies (continued)

2.2 Revenue and profit recognition (continued)

Revenue and profit recognition

Revenue is recognised as performance obligations are satisfied as control of the goods and services is transferred to the customer.

For each performance obligation within a contract, the Company determines whether it is satisfied over time or at a point in time. Performance obligations are satisfied over time if one of the following criteria is satisfied:

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

The Company has determined that most of its contracts satisfy the over-time criteria, either because the customer simultaneously receives and consumes the benefits provided by the Company's performance as it performs (typically services or support contracts) or the Company's performance does not create an asset with an alternative use to the Company and it has an enforceable right to payment for performance completed to date (typically development or production contracts).

For each performance obligation to be recognised over time, the Company recognises revenue using an input method, based on costs incurred in the period. Revenue and attributable margin are calculated by reference to reliable estimates of transaction price and total expected costs, after making suitable allowances for technical and other risks. Revenue and associated margin are therefore recognised progressively as costs are incurred, and as risks have been mitigated or retired. The Company has determined that this method faithfully depicts the Company's performance in transferring control of the goods and services to the customer.

If the over-time criteria for revenue recognition are not met, revenue is recognised at the point in time that control is transferred to the customer, which is usually when legal title passes to the customer and the business has the right to payment, for example, on delivery.

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

Outstanding commitments

The Company regularly reviews outstanding commitment for purchases in its supply chain in order to inform revenue recognition under IFRS 15 trading principles. Where the Company has received notification that the supplier has completed the manufacture of goods, but has not yet delivered and invoiced for them and the ultimate customer controls the asset, i.e. neither the subcontractor or the Company have an alternative use for the asset, the Company will accrue for these costs and recognise revenue in line with overtime trading principles under IFRS 15.

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:

Notes to the Financial Statements

2. Accounting policies (continued)

2.2 Revenue and profit recognition (continued)

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.

2.3 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.

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

2. Accounting policies (continued)

2.4 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 on 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.

2.5 Interest income and borrowing costs

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

2.6 Dividends

Qualifying 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.

2.7 Intangible assets

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

Goodwill

Under the acquisition method for business combinations, goodwill is the acquisition-date fair value of the consideration transferred, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed. Goodwill on acquisitions of businesses is included in intangible assets. Gains and losses on the disposal of a business include the carrying amount of goodwill relating to the business sold.

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 overhead.

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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.7 Intangible assets (continued)

The non-amortisation of goodwill can conflict with the Companies Act 2006 which requires goodwill to be written off over its useful economic life. As such the Company applies the 'true and fair' override available to entities.

The estimated useful lives are as follows:

Software	-	2 to 5 years
Development costs	-	Up to 10 years

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

2.8 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, testing costs 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
Computer equipment and motor vehicles	-	4 to 5 years
Other equipment	-	10 to 20 years, or the project life if shorter

No depreciation is provided on freehold land and assets in the course of construction.

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each Balance Sheet date.

Notes to the Financial Statements

2. Accounting policies (continued)

2.9 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.

2.10 Investments in subsidiary undertakings and participating interests

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

2.11 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. Impairment losses are recognised in the Income Statement.

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.

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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.12 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 foreign translation reserve. The functional currency of the Company is pounds sterling.

2.13 Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value. Inventory cost is valued using the most appropriate method based on the business use of inventory. In the majority of cases this is moving average unit cost, with some businesses using standard cost or first in first out (FIFO) as methods more indicative of their use of inventory.

2.14 Trade, contract and other receivables

Trade and other receivables are stated at amortised cost including a provision for expected credit losses. The Company measures the provision at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Company writes off a trade 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.

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.

2.15 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.

2.16 Trade and other payables

Trade and other payables are stated at amortised cost.

Contract liabilities represent the obligation to transfer goods or services to a customer for which consideration has been received, or consideration is due, from the customer.

2.17 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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.17 Tax (continued)

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.

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.

2.18 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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.18 Provisions (continued)

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.

2.19 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 67. 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 – 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 2023. The surpluses have been recognised on the basis that the future economic benefits are unconditionally available to the Company, which is assumed to be via a refund. These have been recognised after deducting a 35% withholding tax which would be levied prior to the future refunding of any surplus and have been presented on a net basis as this is not deemed to be an income tax of the Company.

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.

Notes to the Financial Statements

2. Accounting policies (continued)

2.19 Post-employment benefits (continued)

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.

2.20 Share-based payments

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

2.21 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. Fair values are estimated by discounting expected future cash flows based on reputable third-party forecast data, and then adjusting for credit risk, including the Company's own credit risk, and market risk.

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 reclassified from the hedging reserve 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. The Company treats the foreign currency basis element of the designated foreign exchange derivative hedging instrument as a cost of hedging and as such it is excluded from the hedge designation.

Notes to the Financial Statements

3. Revenue

Revenue by customer location:

	2023	2022¹
	£m	£m
United Kingdom	1,524	1,148
Rest of Europe	837	731
Kingdom of Saudi Arabia	2,619	2,453
Qatar	448	879
Rest of Middle East	61	77
USA and Canada	1,248	1,132
Asia and Pacific	42	46
Africa, and Central and South America	6	7
	6,785	6,473
	6,785	6,473

¹Revenue figures for 2022 to United Kingdom and Rest of Europe have been re-presented to reflect the workshare on the Typhoon programme.

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 2023 was £19.2bn (2022: £18.0bn).

Revenue of £0.1bn (2022: £0.2bn) was recognised during the year ended 31 December 2023 in respect of performance obligations satisfied or partially satisfied in previous periods.

Notes to the Financial Statements

4. Operating costs

	2023 £m	2022 £m
Inventory recognised as an expense	4,367	4,168
Staff costs (note 8)	1,125	1,131
Depreciation of fixed assets	52	51
Depreciation of right-of-use assets and investment property	20	18
Amortisation of intangible assets	30	27
Impairment of intangible assets and investment property	4	1
Other operating charges	727	553
	6,325	5,949

The remuneration of the auditor for the year ended 31 December 2023 for auditing of the financial statements was £1.1m (2022: £1.1m) and £nil (2022: £nil) in respect of non-audit work.

Total research and development expenditure was £1,101m (2022: £752m), of which £242m (2022: £192m) was funded by the Company.

5. Other income

	2023 £m	2022 £m
Research and development expenditure credits	37	44
Operating lease income	7	6
Impairment write-back of investment property	-	1
Profit on disposal of investment property	5	-
Management recharges	1	2
Other	28	20
	78	73

6. Financial income

	2023 £m	2022 £m
Interest income on cash and other financial instruments	1	-
Interest income on retirement benefit surpluses (note 23)	53	-
Interest income on finance lease receivables	1	1
Interest income in respect of loans to BAE Systems subsidiaries	116	57
Fair value gain on hedging	2	-
	173	58

Notes to the Financial Statements

7. Financial expense

	2023	2022
	£m	£m
Interest expense on retirement benefit obligations (note 23)	2	22
Fair value loss on hedging	-	4
Interest expense on lease liabilities	8	7
	10	33
	10	33

8. Employees

The aggregate staff costs and employee numbers include employees who are contracted with other BAE Systems Group companies but are considered to undertake qualifying work for the Company.

The average monthly number of employees during the year was as follows:

	2023	2022
	No.	No.
Air	13,936	13,659
Electronic Systems	1,491	1,416
HQ	57	48
	15,484	15,123
	15,484	15,123

The aggregate staff costs of Company employees were as follows:

	2023	2022
	£m	£m
Wages and salaries	918	869
Social security costs	91	82
Cost of defined benefit pension scheme (note 23)	63	135
Other post-employment benefit costs (note 23)	5	5
Cost of defined contribution pension scheme (note 23)	25	20
Share-based payments (note 28)	23	20
	1,125	1,131
	1,125	1,131

Notes to the Financial Statements

9. Directors' remuneration

The directors who served during the year were employed by either BAE Systems plc or another Group company and provide their services primarily to those companies. A proportion of their remuneration, reflecting the qualifying services to the Company, is disclosed below. These amounts will not be recharged.

	2023	2022
	£'000	£'000
Directors' remuneration	2,942	2,823
Company contributions to defined contribution pension schemes	8	8
Company contributions to defined benefit pension schemes	122	26
Compensation for loss of office	65	-
	3,137	2,857
	3,137	2,857

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

	2023	2022
	Number of directors	Number of directors
Defined contribution schemes	2	2
Defined benefit schemes	3	3
	5	5

	2023	2022
	Number of directors	Number of directors
Number of directors who exercised share options	5	4
Number of directors in respect of whose qualifying services shares were received or receivable under long-term incentive schemes	4	4
	9	8

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

	2023	2022
	£'000	£'000
Remuneration and amounts receivable under long-term incentive schemes	1,310	1,245
	1,310	1,245
	1,310	1,245

The highest paid director's defined benefit accrued pension and accrued lump sum at 31 December 2023 was £273,000 (2022: £256,000) and £nil (2022: £nil), respectively.

During the year, the highest paid director received shares under a long-term incentive scheme.

Notes to the Financial Statements

10. Tax

Tax expense

	2023 £m	2022 £m
Current tax		
UK:		
Current tax	(32)	(82)
Adjustments in respect of prior years	16	(11)
	(16)	(93)
Deferred tax		
Origination and reversal of temporary differences	(16)	9
Adjustments in respect of prior years	(5)	-
	(21)	9
Tax expense	(37)	(84)

The UK corporation tax rate increased from 19% to 25% with effect from 1 April 2023. A blended rate of 23.52% is used in the reconciliation below to reflect this change (2022: 19.00%).

Reconciliation of tax expense

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

	2023 £m	2022 £m
Profit before tax	707	622
UK corporation tax rate	23.52%	19.00%
Expected tax expense	(166)	(118)
Expenses not tax effected	(2)	(2)
Income not subject to tax	44	47
Research and development tax credits and patent box benefits	1	1
Imputed interest income	(15)	(7)
Chargeable gains	(2)	-
Losses received from group companies	64	3
Adjustments in respect of prior years	11	(11)
Other	(2)	-
Pensions	30	3
Tax expense	(37)	(84)

Notes to the Financial Statements

10. Tax (continued)

Tax recognised in other comprehensive income

	2023			2022		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
Items that will not be reclassified to the Income Statement:						
Remeasurements on retirement benefit schemes	(358)	(3)	(361)	1,711	(251)	1,460
Items that may be reclassified to the Income Statement:						
Fair value gain arising on hedging instruments during the period	49	(12)	37	(96)	24	(72)
Cumulative fair value (gain)/loss on hedging instruments reclassified to the income statement	(2)	-	(2)	21	(5)	16
	(311)	(15)	(326)	1,636	(232)	1,404

Notes to the Financial Statements

10. Tax (continued)

	2023			2022		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Post-employment benefit schemes	-	32	32	-	26	26
	-	32	32	-	26	26
Deferred tax						
Financial instruments	(12)	-	(12)	19	-	19
Post-employment benefit schemes	-	(35)	(35)	-	(277)	(277)
	(12)	(35)	(47)	19	(277)	(258)
Tax on other comprehensive income	(12)	(3)	(15)	19	(251)	(232)

On 20 June 2023, Finance (No. 2) Act 2023 was substantively enacted in the UK, including legislation to implement the Organisation for Economic Co-operation and Development's Pillar Two income taxes rules. The Company, as part of the wider BAE Group is within the scope of the rules and the first period for which a Pillar Two tax return will be required for the BAE Group is the accounting period ending on 31 December 2024.

Notes to the Financial Statements

11. Intangible assets

	Goodwill £m	Software £m	Development expenditure £m	Other £m	Total £m
Cost					
At 1 January 2023	29	208	15	4	256
Additions - acquired separately	-	35	-	-	35
Additions - internally developed	-	6	-	-	6
Disposals	-	(2)	-	-	(2)
At 31 December 2023	29	247	15	4	295
Amortisation					
At 1 January 2023	-	147	15	4	166
Amortisation charge	-	30	-	-	30
Disposals	-	(2)	-	-	(2)
Impairment charge	-	2	-	-	2
At 31 December 2023	-	177	15	4	196
Net book value					
At 31 December 2023	29	70	-	-	99
At 31 December 2022	29	61	-	-	90

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 global economic uncertainty and climate change. Pre-tax discount rates, derived from the Company's post-tax weighted average cost of capital and adjusted for factors specific to the market in which the companies operate, have been used in discounting these projected risk-adjusted cash flows.

Capital commitments

Capital expenditure contracted for but not provided for in full in the financial statements is £21m (2022: £9m).

Notes to the Financial Statements

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Total £m
Cost or valuation			
At 1 January 2023	122	946	1,068
Additions	6	64	70
Disposals	(18)	(14)	(32)
At 31 December 2023	110	996	1,106
Depreciation			
At 1 January 2023	46	602	648
Depreciation charge for the year	3	49	52
Disposals	(13)	(14)	(27)
At 31 December 2023	36	637	673
Net book value			
At 31 December 2023	74	359	433
At 31 December 2022	76	344	420
Non-depreciated assets:			
Assets in the course of construction			
At 31 December 2023	2	69	71
At 31 December 2022	16	66	82

Capital commitments

Capital expenditure contracted for but not provided for in full in the financial statements is £37m (2022: £43m).

Notes to the Financial Statements

13. Leases

The Company leases land, buildings, vehicles and equipment under non-cancellable lease arrangements. There are no terms that represent unusual arrangements or create material onerous or beneficial rights or obligations.

	2023			2022		
	Land and buildings £m	Plant and machinery £m	Total £m	Land and buildings £m	Plant and machinery £m	Total £m
Opening net book value as at 1 January	154	2	156	158	2	160
Additions during the year	25	3	28	8	1	9
Depreciation expense for the year	(15)	(1)	(16)	(12)	(1)	(13)
Closing net book value as 31 December	164	4	168	154	2	156

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.

	2023 £m	2022 £m
Payments due:		
Within one year	28	25
Between one and five years	103	96
Later than five years	154	156
	285	277
Impact of discounting	(43)	(44)
Total discounted lease liability	242	233

The total cash outflow for leases recognised on the Balance Sheet in the year ended 31 December 2023, amounted to £28m (2022: 26m).

Notes to the Financial Statements

14. Investment property

	Investment property £m
Cost	
At 1 January 2023	68
At 31 December 2023	68
Depreciation and impairment	
At 1 January 2023	17
Depreciation charge for the year	4
Impairment charge for the year	2
At 31 December 2023	23
Net book value	
At 31 December 2023	45
At 31 December 2022	51
Fair Value	
At 31 December 2023	47
At 31 December 2022	55

The fair values above are based on and reflect current market values as prepared by in-house professionals who have the appropriate professional qualifications and recent experience of valuing properties in the location and of the type being valued.

Notes to the Financial Statements

15. Investments in subsidiary undertakings and participating interests

	£m
Net book value	
At 1 January and 31 December 2023	<u>1</u>

Impairment testing

During the year, management conducted an impairment review of the investment held by the Company. As a result of this review, no impairment reversals were required.

Subsidiary undertakings and participating interests at 31 December 2023

In accordance with Section 409 of the Companies Act 2006, a full list of subsidiary undertakings and significant holdings as at 31 December 2023 is disclosed below. All subsidiary undertakings and significant holdings are owned directly by the Company and have a financial year end of 31 December. The registered office address is Victory Point, Lyon Way, Frimley, Camberley, Surrey GU16 7EX, England.

Company name	Class of shares held	Proportion of class (%)
BAE Systems (Kazakhstan) Limited	Ordinary shares of £1	100
BAE Systems Deployed Systems Limited	Ordinary shares of £1	60

Notes to the Financial Statements

16. Trade, contract and receivables

	2023 £m	2022 £m
Non-current		
Contract receivables	3	1
Amounts owed by parents of BAE Systems (Operations) Limited	7,472	6,514
Amounts owed by other Group subsidiaries	451	444
Prepayments	16	13
Finance lease receivables	15	18
Other receivables	20	30
	7,977	7,020
	7,977	7,020
Current		
Contract receivables	889	1,027
Trade receivables	352	623
Amounts owed by BAE Systems Group joint ventures	33	68
Prepayments	940	498
Accrued income	8	3
Finance lease receivables	4	4
Other receivables	355	459
	2,581	2,682
	2,581	2,682

Current amounts owed by BAE Systems plc and its subsidiaries are payable on demand and are expected to be settled in the Company's usual operating cycle of 12 months or less. No interest is applied to amounts owed and they are unsecured.

The impact of discounting non-current amounts owed by BAE Systems plc and its subsidiaries is not material so has not been applied. Non-Current Amounts owed by BAE Systems plc and its subsidiaries are payable on demand and are not expected to be settled in the Company's usual operating cycle of 12 months or less. Whilst the majority of these receivables are interest free, certain balances bear interest priced on an arm's length basis.

Notes to the Financial Statements

17. Other financial assets and liabilities

	2023 £m	2022 £m
Financial assets		
Non-current		
Cash flow hedges – foreign exchange contracts	<u>84</u>	<u>101</u>
Current		
Cash flow hedges – foreign exchange contracts	<u>102</u>	<u>146</u>
Financial liabilities		
Non-current		
Cash flow hedges – foreign exchange contracts	<u>(90)</u>	<u>(177)</u>
Current		
Cash flow hedges – foreign exchange contracts	<u>(123)</u>	<u>(164)</u>

18. Deferred taxation

Movement in temporary differences during the year

	As at 1 January 2023 £m	Recognised in income £m	Recognised in equity £m	As at 31 December 2023 £m
Property, plant and equipment	21	(16)	-	5
Provisions and accruals	9	(4)	-	5
Retirement benefit schemes:				
Additional contributions spread forward	35	-	(35)	-
Share-based payments	3	-	3	6
Financial instruments	24	-	(19)	5
	<u>92</u>	<u>(20)</u>	<u>(51)</u>	<u>21</u>

Notes to the Financial Statements

18. Deferred taxation (continued)

	As at 1 January 2022 £m	Recognised in income £m	Recognised in equity £m	As at 31 December 2022 £m
Property, plant and equipment	19	2	-	21
Provisions and accruals	5	4	-	9
Retirement benefit schemes:				
Deficits	253	-	(253)	-
Additional contributions spread forward	59	-	(24)	35
Share-based payments	1	-	2	3
Financial instruments	(6)	3	27	24
	<u>331</u>	<u>9</u>	<u>(248)</u>	<u>92</u>

19. Inventories

	2023 £m	2022 £m
Raw materials and consumables	196	157
Work in progress	37	20
	<u>233</u>	<u>177</u>

The Company recognised £nil (2022 £nil) as a write down of inventories to net realisable value.

Notes to the Financial Statements

20. Current tax

	2023 £m	2022 £m
Tax provisions	(39)	(39)
Research and development expenditure credits receivable	90	106
Other	116	38
	167	105
	167	105
Represented by:		
Current tax assets	167	105
	167	105
	167	105

21. Contract liabilities

	2023 £m	2022 £m
Non-current		
Contract liabilities	1,062	242
	1,062	242
Current		
Contract liabilities	2,518	2,711
	2,518	2,711
	2,518	2,711

Revenue recognised in the year includes £2,520m (2022: £1,441m) that was included in the opening contract liabilities balance. Non-current and current contract liabilities as at 1 January 2022 were £230m and £1,751m, respectively.

The increase in contract liabilities since 2022 is primarily due to customer advances received during the year.

Notes to the Financial Statements

22. Trade and other payables

	2023 £m	2022 £m
Non-current		
Amounts owed to BAE Systems Group joint ventures	10	8
Accruals	14	15
	<u>24</u>	<u>23</u>
Current		
Trade payables	85	88
Amounts owed to parents of BAE Systems (Operations) Limited	2,687	2,168
Amounts owed to other Group subsidiaries	223	341
Amounts owed to BAE Systems Group joint ventures	11	33
Other taxes and social security costs	13	22
Accruals	969	1,071
Deferred income	1	32
Other payables	127	102
	<u>4,116</u>	<u>3,857</u>

Amounts owed to BAE Systems plc and its subsidiaries are payable on demand and are unsecured. Whilst the majority of these payables are interest free, certain balances bear interest priced on an arm's length basis.

Notes to the Financial Statements

23. 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 pages 44-45.

At 31 December 2023, the weighted average durations of the UK defined benefit pension obligations were 13 years (2022: 13 years).

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

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	28	21	51
Royal Ordnance Pension Scheme ²	12	16	72

¹Source: 31 March 2021 actuarial valuation reports.

²Source: Royal Ordnance Pension Scheme actuarial valuation 31 March 2022.

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.baesystems.com/en-pensions/home.

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 2023.

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 67 - 73.

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.

Notes to the Financial Statements

23. Post-employment benefits (continued)

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 67. 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 accelerated payment in 2021 of the remaining sponsor deficit reduction contributions under the previously agreed deficit recovery plan, BAE Systems plc and the Trustees agreed to carry out an early triennial funding valuation for the Main Scheme as at 31 March 2021, this valuation was concluded and signed off on 30 June 2022.

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 March 2021 £bn	ROPS as at 31 March 2022 £bn
Market value of assets	22.9	1.5
Present value of liabilities	(22.9)	(1.5)
Funding surplus	-	-
Percentage of accrued benefits covered by the assets at the valuation date	100%	102%

The valuations in 2020 and 2021 were determined using the following mortality assumptions:

Life expectancy of a male currently aged 65 (years)	86 – 89
Life expectancy of a female currently aged 65 (years)	87 – 90
Life expectancy of a male currently aged 45 (years)	88 – 91
Life expectancy of a female currently aged 45 (years)	90 – 93

As part of the process of the Main Scheme's 2021 valuation, the Trustees and BAE Systems plc agreed to update the methodology to use a cash flow matching strategy, such that assets are invested with the aim of the expected income directly matching the expected benefit payments of the Scheme. The cash flow matching strategy aims to manage risk through a defined amount of risk buffer assets, which equate to the agreed prudence margin in the valuation. The risk buffer assets are measured over time to assure the Scheme is sufficiently funded. The asset portfolio is currently invested in a selection of bonds designed to match the pension payments for current pensioners, as well as a mix of growth seeking assets aimed to generate returns for the pension payments for future pensioners. Over time, assets from the return seeking portfolio will be realised to purchase additional, lower risk assets to match the increasing current pensioner portfolio. The valuations for the other schemes use a different method in that discount rates 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.

Notes to the Financial Statements

23. Post-employment benefits (continued)

The inflation assumptions for each of the valuations were derived 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.

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.

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

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

Contributions

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

The total Company contributions made to the defined benefit schemes in the year ended 31 December 2023 were £175m (2022 £169m). Contributions in 2024 are expected to be at a similar level to 2023.

Notes to the Financial Statements

23. 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	
<p>Asset returns may not move in line with the liabilities and may be subject to volatility.</p>	<p>The investment portfolios are highly diversified, investing in a wide range of assets, in order to reduce the exposure of the total portfolio to a materially adverse impact from a single security or type of security. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities.</p> <p>Some 38% (2022 46%) of the UK pension scheme assets are held in equities and pooled investment vehicles due to the higher expected level of return over the long term.</p> <p>The UK Main Scheme reduced its allocation to equities significantly over the course of 2023, and closed out its equity option strategy to reflect its limited resultant exposure to equity markets.</p> <p>Environmental (including exposure to climate related risks), Social and Governance (ESG) factors are incorporated into the investment analysis and decision-making process carried out by the Trustees of the UK schemes. There is alignment between the UK Main Scheme and Company's climate change objectives with consistent long-term net zero ambitions.</p>
Interest rate risk	
<p>Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.</p>	<p>As part of the funding valuation finalised during 2022, the main UK Scheme has adopted a cash flow matching strategy, whereby contractual income from assets is designed to directly match benefits paid to members each year. A portfolio of assets with contractual income has been structured to match benefits already in payment, representing around half of the liabilities. This inherently hedges the associated interest rate risk. As members retire and become pensioners, additional matching assets will be purchased to keep pace. Interest rate risk associated with the remaining purchase of matching assets is mitigated via a hedging strategy involving mainly physical assets rather than derivatives and only modest levels of leverage. The overall level of interest rate hedging on the funding basis has increased compared to 2022.</p>
Inflation risk	
<p>Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.</p>	<p>The main UK Scheme's cash flow matching strategy includes aligning asset income to the inflation-linked members' benefit payments. Inflation risk is mitigated by the presence of caps on most inflation linked benefits and via a hedging strategy, executed with several banks to reduce counterparty risk. The overall level of inflation hedging on the funding basis has increased compared 2022.</p> <p>In 2014, the Main Scheme implemented a pension increase exchange to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases.</p>
Longevity risk	
<p>Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.</p>	<p>Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees.</p> <p>In 2013, with the agreement of BAE Systems plc, the Trustees of the 2000 Plan, Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme (SIPS) entered into arrangements with Legal & General to insure against longevity risk for the current pensioner population, covering a total of £4.4bn of pension scheme liabilities. These arrangements reduce the funding volatility relating to increasing life expectancy. This longevity risk cover with Legal & General remains in place following the merger of the 2000 Plan and SIPS into the Main Scheme.</p>

Notes to the Financial Statements

23. Post-employment benefits (continued)

Virgin media case

The Company is aware of the ongoing 'Virgin Media v NTL Pension Trustees Ltd and others' case and that there is a potential for the outcome of the case to have an impact on the UK schemes. The case affects defined benefit schemes that provided contracted-out benefits before 6 April 2016 based on meeting the reference scheme test. Where scheme rules were amended, potentially impacting benefits accrued from 6 April 1997 to 6 April 2016, schemes needed the actuary to confirm that the reference scheme test was still being met by providing written confirmation under Section 37 of the Pension Schemes Act 1993. In the Virgin Media case the judge ruled that alterations to the scheme rules were void and ineffective because of the absence of written actuarial confirmation required under Section 37 of the Pension Schemes Act 1993. The case has been taken to The Court of Appeal, with the hearing set for June 2024. The potential impact on the UK schemes is not yet known but continues to be assessed.

IAS 19 Accounting

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

Principal actuarial assumptions

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the long-term nature of the obligation covered, may not necessarily occur in practice.

	2023	2022	2021
Financial assumptions			
Discount rate – past service (%)	4.5	4.8	1.9
Discount rate – future service (%)	4.6	4.8	1.9
Retail Prices Index (RPI) inflation (%)	2.8	3.0	3.1
Rate of increase in salaries (%)	2.8	3.0	3.1
Rate of increase in deferred pensions (%)	2.1/2.8	2.3/3.0	2.4/3.1
Rate of increase in pensions in payment (%)	1.6 – 3.6	1.7 – 3.6	1.7 – 3.7
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	85 – 89	86 – 89	86 – 89
Life expectancy of a female currently aged 65 (years)	88 – 89	88 – 90	88 – 90
Life expectancy of a male currently aged 45 (years)	86 – 89	87 – 90	86 – 90
Life expectancy of a female currently aged 45 (years)	89 – 90	89 – 91	89 – 91

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments using a third-party AA corporate bond yield curve to produce a single equivalent discount rate. 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 58.

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. 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.

The inflation risk premium deduction has been set at 0.55% per annum (2022 0.55%) and the CPI assumption has been set at 0.7% per annum (2022 0.7%) lower than RPI. The resulting RPI assumption is 2.8% per annum and the CPI assumption is 2.1% 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.

Notes to the Financial Statements

23. Post-employment benefits (continued)

Rate of increase in salaries

The rate of increase in salaries for the UK schemes is assumed to be RPI inflation of 2.8% (2022 RPI inflation of 3.0%), plus a promotional scale.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on CPI inflation of 2.1% (2022 CPI inflation of 2.3%), with the exception of the legacy 2000 Plan, which is based on RPI inflation of 2.8% (2022 RPI inflation of 3.0%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

Rate of increase in pensions in payment

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

Life expectancy

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 2022 tables (published by the Institute of Actuaries) have been used (in 2022, the Continuous Mortality Investigation 2021 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.0% per annum (2022 1.0%), an initial rate adjustment parameter ('A') of 0.2% (2022 0.25%) in conjunction with a smoothing parameter ('Sk') of 7 for all members (2022 7) and the following weighting ('W') parameters: W2022 35% (2022 n/a); W2021 0% (2022 7.5%); and W2020 0% (2022 7.5%).

The disclosures below are in respect of the Company's share of the IAS 19 deficit using the allocation methodology outlined on pages 44-45.

Summary of movements in retirement benefit obligations

	Defined benefit pension schemes £m	Saudi Arabia end of service benefit £m	Total £m
Company's share of IAS 19 surplus at 1 January 2023 (net of withholding tax)	649	(38)	611
Add back: withholding tax on surpluses	355	-	355
Company's share of IAS 19 surplus at 1 January 2023	1,004	(38)	966
Actual return on assets excluding amounts included in net finance costs	(222)	-	(222)
Increase in liabilities due to changes in assumptions and experience	(256)	(3)	(259)
Contributions in excess of service cost	75	-	75
Net interest income	53	(2)	51
Foreign exchange adjustments	-	2	2
Withholding tax on surpluses	(232)	-	(232)
Company's share of IAS 19 surplus at 31 December 2023	422	(41)	381

Notes to the Financial Statements

23. Post-employment benefits (continued)

Surplus recognition

All UK schemes are in an accounting surplus position. The surpluses have been recognised on the basis that the future economic benefits are unconditionally available to the Company, which is assumed to be via a refund. On 22 November 2023, the UK government announced that the authorised surplus payments charge would be reduced from 35% to 25% from 6 April 2024. The Company considers this to be a non-adjusting post balance sheet event and the surplus has been recognised net of withholding tax of 35% at 31 December 2023 (2022: 35%) based on the enacted legislation at that date. Should the legislation have been enacted at year-end, this would have resulted in an £61m increase in the pension surplus. This tax would be levied prior to the future refunding of any surplus and therefore the surplus has been presented on a net basis as this is not deemed to be an income tax of the Group.

Amounts recognised in the Balance Sheet

	Defined benefit pension schemes 2023 £m	Saudi Arabia end of service benefit 2023 £m	Total 2023 £m	Defined benefit pension schemes 2022 £m	Saudi Arabia end of service benefit 2022 £m	Total 2022 £m
Present value of unfunded obligations	(10)	(41)	(51)	(11)	(38)	(49)
Present value of funded obligations	(10,417)	-	(10,417)	(10,145)	-	(10,145)
Fair value of scheme assets	11,081	-	11,081	11,160	-	11,160
Withholding tax on surpluses	(232)	-	(232)	(355)	-	(355)
Company's share of IAS 19 (deficit)/surplus, net	422	(41)	381	649	(38)	611
Represented by:						
Retirement benefit surpluses	432	-	432	660	-	660
Retirement benefit obligations	(10)	(41)	(51)	(11)	(38)	(49)
	422	(41)	381	649	(38)	611

Notes to the Financial Statements

23. 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 2022	13,382	-	13,382
<i>Interest income</i>	252	-	252
<i>Actual return on assets excluding amounts included in interest income</i>	(2,057)	-	(2,057)
Actual return on assets	(1,805)	-	(1,805)
<i>Contributions by employer</i>	131	5	136
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	38	-	38
Total contributions by employer	169	5	174
Members' contributions	3	-	3
Administrative expenses	(8)	-	(8)
Benefits paid	(581)	(5)	(586)
Company's share of the value of scheme assets at 31 December 2022	11,160	-	11,160
<i>Interest income</i>	526	-	526
<i>Actual return on assets excluding amounts included in interest income</i>	(222)	-	(222)
Actual return on assets	304	-	304
<i>Contributions by employer</i>	138	5	143
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	37	-	37
Total contributions by employer	175	5	180
Members' contributions	3	-	3
Administrative expenses	(11)	-	(11)
Benefits paid	(550)	(5)	(555)
Company's share of the value of scheme assets at 31 December 2023	11,081	-	11,081

Notes to the Financial Statements

23. Post-employment benefits (continued)

Assets of defined benefit pension schemes

	2023			2022		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	1	-	1	115	-	115
Overseas	97	-	97	323	-	323
Pooled investment vehicles ¹	-	4,160	4,160	2	4,718	4,720
Fixed interest securities:						
UK gilts	1,160	-	1,160	1,149	-	1,149
UK corporates	1,517	944	2,461	943	1,298	2,241
Overseas government	19	-	19	16	-	16
Overseas corporates	849	-	849	599	30	629
Index-linked securities:						
UK gilts	997	-	997	872	-	872
UK corporates	569	-	569	-	487	487
Overseas corporates	18	-	18	5	-	5
Property ²	-	782	782	-	934	934
Derivatives ³	-	(504)	(504)	-	(653)	(653)
Cash:						
Sterling	314	29	343	306	14	320
Foreign currency	134	-	134	7	-	7
Other	-	(5)	(5)	-	(5)	(5)
Company total	5,675	5,406	11,081	4,337	6,823	11,160

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 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. 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 2023, 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

23. 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 2022	(14,407)	(45)	(14,452)
<i>Current service cost</i>	(127)	(5)	(132)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(38)	-	(38)
Total current service cost	(165)	(5)	(170)
Members' contributions	(3)	-	(3)
Actuarial gain due to changes in assumptions and experience	4,110	13	4,123
Interest expense	(272)	(2)	(274)
Benefits paid	581	5	586
Foreign exchange translation	-	(4)	(4)
Company's share of the defined benefit obligations at 31 December 2022	(10,156)	(38)	(10,194)
<i>Current service cost</i>	(52)	(5)	(57)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(37)	-	(37)
Total current service cost	(89)	(5)	(94)
Members' contributions	(3)	-	(3)
Actuarial loss due to changes in assumptions and experience	(256)	(3)	(259)
Interest expense	(473)	(2)	(475)
Benefits paid	550	5	555
Foreign exchange translation	-	2	2
Company's share of the defined benefit obligations at 31 December 2023	(10,427)	(41)	(10,468)

Amounts recognised in the Income Statement

	UK defined benefit pension schemes 2023 £m	Saudi Arabia end of services benefit 2023 £m	Total 2023 £m	UK defined benefit pension schemes 2022 £m	Saudi Arabia end of services benefit 2022 £m	Total 2022 £m
Included in operating costs:						
Current service cost	(52)	(5)	(57)	(127)	(5)	(132)
Administrative expenses	(11)	-	(11)	(8)	-	(8)
	(63)	(5)	(68)	(135)	(5)	(140)
Included in finance costs:						
Net interest income on retirement benefit obligations	53	(2)	51	(20)	(2)	(22)

The Company incurred a charge of £25m (2022 £20m) in relation to defined contribution schemes for employees.

Notes to the Financial Statements

23. Post-employment benefits (continued)

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2023 and keeping all other assumptions as set out on page 67.

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 30, these valuations are subject to estimation uncertainty as their valuation techniques incorporate a number of assumptions, including those associated with 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 ¹ £bn	Increase/ (decrease) in scheme assets ¹ £bn
Discount rate:		
0.5 percentage point increase	0.6	(0.6)
0.5 percentage point decrease	(0.7)	0.7
1.0 percentage point increase	1.2	(1.2)
1.0 percentage point decrease	(1.5)	1.5
2.0 percentage point increase	2.1	(2.1)
2.0 percentage point decrease	(3.3)	3.4
3.0 percentage point increase	2.9	(2.8)
3.0 percentage point decrease	(5.6)	5.8
Inflation:		
0.1 percentage point increase	(0.1)	0.1
0.1 percentage point decrease	0.1	(0.1)
0.5 percentage point increase	(0.4)	0.4
0.5 percentage point decrease	0.3	(0.4)
1.0 percentage point increase	(0.7)	0.9
1.0 percentage point decrease	0.7	(0.8)

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 surplus:

	(Decrease)/ increase in net surplus ¹ £m
Life expectancy:	
One-year increase	(0.4)
One-year decrease	0.4

¹Before deduction of withholding tax.

Notes to the Financial Statements

24. Provisions

	Warranties and after- sales service £m	Reorganisations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	11	-	2	2	15
Current	11	4	4	5	24
At 1 January 2023	22	4	6	7	39
Released	(3)	-	(4)	(4)	(11)
Created	4	-	31	21	56
Utilised in year	(3)	(3)	(2)	(2)	(10)
At 31 December 2023	20	1	31	22	74
Represented by:					
Non-current	8	-	1	11	20
Current	12	1	30	11	54
	20	1	31	22	74

Warranties and after-sales service

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

Reorganisations

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

Legal, contractual and environmental

Reflecting the inherent uncertainty within many legal proceedings and other factors, the amount of the outflows could differ significantly from the amount provided and the timing of the outflows cannot be reliably estimated.

Other

There are no individually significant provisions included within other provisions.

Notes to the Financial Statements

25. Share capital and other reserves

Share capital

	£1 Ordinary shares	£1 'B' Ordinary shares	Nominal value £m
Issued and fully paid			
At 1 January 2022, 31 December 2022 and 31 December 2023	1,007,340,000	180,000	1,008
Other reserves			
	Translation reserves £m	Hedging reserve £m	Total £m
At 1 January 2022	(7)	24	17
Net amounts debited to hedging reserve (net of tax)	-	(82)	(82)
At 31 December 2022	(7)	(58)	(65)
Net amounts credited to hedging reserve (net of tax)	-	39	39
At 31 December 2023	(7)	(19)	(26)

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 operations.

Notes to the Financial Statements

26. Dividends

	2023 £m	2022 £m
Final dividend of 52.61p (2022: 31.26p) per ordinary share proposed and paid during the year relating to the previous year's results.	530	315

The directors are proposing a final dividend of 65.52p (2022: 52.61p) per share totalling £660m (2022: £530m).

This dividend has not been accrued in the Balance Sheet.

27. 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:

	2023 Sales £m	2023 Debtors £m	2023 Purchases £m	2023 Creditors £m
Related party				
International Systems Engineering Company Limited	-	-	88	13
Granada Enterprises Limited	-	-	139	2
BAE Systems Saudi Development and Training Company Limited	-	1	558	8
Saudi Maintenance & Supply Chain Management Company Limited	27	-	466	72
Non wholly-owned BAE Systems Group subsidiaries	<u>27</u>	<u>1</u>	<u>1,251</u>	<u>95</u>
BAE Systems Strategic Aerospace Services WLL	-	-	30	8
Eurofighter Jagdflugzeug GmbH	1,377	31	190	13
MBDA SAS	2	1	258	-
Panavia Aircraft GmbH	33	1	3	-
BAE Systems Group joint ventures	<u>1,412</u>	<u>33</u>	<u>481</u>	<u>21</u>
BAE Systems Group pension schemes	<u>-</u>	<u>-</u>	<u>24</u>	<u>202</u>

Notes to the Financial Statements

27. Related party transactions (continued)

Related party	2022 Sales £m	2022 Debtors £m	2022 Purchases £m	2022 Creditors £m
International Systems Engineering Company Limited	-	-	79	35
Granada Enterprises Limited	-	-	150	45
BAE Systems Saudi Development and Training Company Limited	-	1	556	99
Saudi Maintenance & Supply Chain Management Company Limited	8	3	410	53
Non wholly-owned BAE Systems Group subsidiaries	8	4	1,195	232
BAE Systems Strategic Aerospace Services WLL	-	-	27	8
Eurofighter Jagdflugzeug GmbH	1,219	67	383	33
MBDA SAS	1	-	76	-
Panavia Aircraft GmbH	22	1	4	-
Sealand Support Services Limited	1	-	-	-
Rheinmetall BAE Systems Land (RBSL)	1	-	-	-
BAE Systems Group joint ventures	1,244	68	490	41
BAE Systems Group pension schemes	-	-	20	193

28. 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.

	Range of exercise price of outstanding options (£) 2023	Weighted average remaining contracted life (years) 2023	Range of exercise price of outstanding options (£) 2022	Weighted average remaining contracted life (years) 2022
Executive Share Option Plan	4.12 – 7.83	7	3.89 – 7.83	8
Performance Share Plan	-	5	-	5

The average share price of BAE Systems plc in the year was £9.77 (2022 £7.53).

Notes to the Financial Statements

29. Post Balance Sheet events

At 31 December 2023, BAE Systems (Kazakhstan) Limited, a subsidiary of the Company, held a 49% shareholding in Air Astana.

On 12 January 2024, Air Astana announced its intention to proceed with a joint initial public offering (IPO) on the London Stock Exchange, the Astana International Exchange in Kazakhstan, and the Kazakhstan Stock Exchange. On 9 February 2024, the IPO was launched. As a result of the IPO, the Company's indirect shareholding in Air Astana has reduced from 49% to 16.95%.

30. Controlling parties

The immediate parent company is BAE Systems Enterprises Limited and the ultimate parent company and 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