

# Financial statements

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The first of class Type 45 destroyer, HMS Daring, successfully completed her stage one sea trials on schedule in August 2007.

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We have audited the Group and parent company financial statements (the 'financial statements') of BAE Systems plc for the year ended 31 December 2007 which comprise the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. 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.

## Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, and for preparing the parent company financial statements and the Directors' Remuneration Report in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities on page 86.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

## Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

## Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2007 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the parent company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the parent company's affairs as at 31 December 2007;
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

## KPMG Audit Plc

Chartered Accountants  
Registered Auditor  
London

20 February 2008

## Notes:

1. The maintenance and integrity of the BAE Systems plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Consolidated income statement

for the year ended 31 December

	Notes	2007 £m	Total 2007 £m	2006 £m	Total 2006 £m
<b>Continuing operations</b>					
<b>Combined sales of Group and equity accounted investments</b>	3		<b>15,710</b>		13,765
Less: share of equity accounted investments	3		<b>(1,401)</b>		(1,432)
<b>Revenue</b>	3		<b>14,309</b>		12,333
<b>Operating costs</b>	4		<b>(13,480)</b>		(11,763)
<b>Other income</b>	5		<b>209</b>		371
<i>Group operating profit excluding amortisation and impairment of intangible assets</i>			<b>1,335</b>		1,080
Amortisation	11		<b>(149)</b>		(105)
Impairment	11		<b>(148)</b>		(34)
<b>Group operating profit</b>			<b>1,038</b>		941
<i>Share of results of equity accounted investments excluding finance costs and taxation expense</i>			<b>142</b>		127
<i>Financial income of equity accounted investments</i>			<b>35</b>		21
<i>Taxation expense of equity accounted investments</i>			<b>(38)</b>		(35)
<b>Share of results of equity accounted investments</b>	14		<b>139</b>		113
<i>Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA)</i>			<b>1,477</b>		1,207
Amortisation			<b>(149)</b>		(105)
Impairment			<b>(148)</b>		(34)
<i>Financial income of equity accounted investments</i>			<b>35</b>		21
<i>Taxation expense of equity accounted investments</i>			<b>(38)</b>		(35)
<b>Operating profit</b>	3		<b>1,177</b>		1,054
<b>Finance costs</b>	6				
Financial income			<b>1,257</b>		1,330
Financial expense			<b>(1,199)</b>		(1,525)
			<b>58</b>		(195)
<b>Profit before taxation</b>			<b>1,235</b>		859
<b>Taxation expense</b>	8				
UK taxation			<b>(201)</b>		(97)
Overseas taxation			<b>(134)</b>		(116)
			<b>(335)</b>		(213)
<b>Profit for the year from continuing operations</b>			<b>900</b>		646
<b>Profit for the year from discontinued operations</b>	9		<b>22</b>		993
<b>Profit for the year</b>			<b>922</b>		1,639
<b>Attributable to:</b>					
BAE Systems shareholders			<b>901</b>		1,636
Minority interests			<b>21</b>		3
			<b>922</b>		1,639
<b>Earnings per share</b>					
	10				
Continuing operations:					
Basic earnings per share			<b>26.0p</b>		19.9p
Diluted earnings per share			<b>25.8p</b>		19.8p
Discontinued operations:					
Basic earnings per share			<b>0.6p</b>		30.8p
Diluted earnings per share			<b>0.6p</b>		29.4p
Total:					
Basic earnings per share			<b>26.6p</b>		50.7p
Diluted earnings per share			<b>26.4p</b>		49.2p

# Consolidated balance sheet

as at 31 December

	Notes	2007 £m	2006 £m
<b>Non-current assets</b>			
Intangible assets	11	9,559	7,595
Property, plant and equipment	12	1,774	1,746
Investment property	13	113	123
Equity accounted investments	14	781	671
Other investments	15	6	11
Other receivables	16	322	569
Other financial assets	17	48	51
Deferred tax assets	8	567	1,077
		<b>13,170</b>	<b>11,843</b>
<b>Current assets</b>			
Inventories	18	701	395
Trade and other receivables including amounts due from customers for contract work	16	2,933	2,253
Current tax		35	3
Other investments	15	164	503
Other financial assets	17	101	50
Cash and cash equivalents		3,062	3,100
		<b>6,996</b>	<b>6,304</b>
Non-current assets and disposal groups held for sale	19	94	-
		<b>7,090</b>	<b>6,304</b>
<b>Total assets</b>	3	<b>20,260</b>	<b>18,147</b>
<b>Non-current liabilities</b>			
Loans	20	(2,197)	(2,776)
Trade and other payables	21	(413)	(465)
Retirement benefit obligations	22	(1,629)	(2,499)
Other financial liabilities	17	(26)	(45)
Deferred tax liabilities	8	(40)	(15)
Provisions	23	(399)	(271)
		<b>(4,704)</b>	<b>(6,071)</b>
<b>Current liabilities</b>			
Loans and overdrafts	20	(299)	(334)
Trade and other payables	21	(8,245)	(6,717)
Other financial liabilities	17	(71)	(50)
Current tax		(499)	(417)
Provisions	23	(410)	(424)
		<b>(9,524)</b>	<b>(7,942)</b>
Liabilities directly associated with disposal groups held for sale	19	(30)	-
		<b>(9,554)</b>	<b>(7,942)</b>
<b>Total liabilities</b>	3	<b>(14,258)</b>	<b>(14,013)</b>
<b>Net assets</b>		<b>6,002</b>	<b>4,134</b>
<b>Capital and reserves</b>			
Issued share capital	25,27	90	81
Share premium	27	1,222	841
Equity option of convertible preference shares	27	-	76
Other reserves	27	4,631	4,330
Retained earnings	27	23	(1,211)
<b>Total equity attributable to equity holders of the parent</b>		<b>5,966</b>	<b>4,117</b>
<b>Minority interests</b>	27	<b>36</b>	<b>17</b>
<b>Total equity</b>		<b>6,002</b>	<b>4,134</b>

Approved by the Board on 20 February 2008 and signed on its behalf by:

M J Turner  
Chief Executive

G W Rose  
Group Finance Director

# Consolidated cash flow statement

for the year ended 31 December

	Notes	2007 £m	2006 £m
Profit for the year from continuing operations		900	646
Profit for the year from discontinued operations		22	993
<b>Profit for the year</b>		<b>922</b>	<b>1,639</b>
Taxation expense – continuing operations		335	213
Taxation expense – discontinued operations		-	4
Share of results of equity accounted investments – continuing operations	14	(139)	(113)
Share of results of equity accounted investments – discontinued operations		-	(70)
Net finance costs – continuing operations		(58)	195
Net finance costs – discontinued operations		-	(2)
Depreciation, amortisation and impairment		610	422
Loss/(gain) on disposal of property, plant and equipment	4,5	3	(60)
Gain on disposal of investment property	5	(47)	(84)
Gain on disposal of non-current other investments		(8)	-
Gain on disposal of businesses – continuing operations	4,5	(40)	(13)
Gain on disposal of businesses – discontinued operations	9	(22)	(925)
Impairment of other investments	15	-	2
Cost of equity-settled employee share schemes		34	21
Movements in provisions		52	47
Decrease in liabilities for retirement benefit obligations		(233)	(834)
(Increase)/decrease in working capital:			
Inventories		(188)	28
Trade and other receivables		(271)	(187)
Trade and other payables		1,212	495
Cash inflow from operating activities		2,162	778
Interest paid		(224)	(315)
Interest element of finance lease rental payments		(6)	(11)
Taxation paid		(112)	(85)
<b>Net cash inflow from operating activities</b>		<b>1,820</b>	<b>367</b>
Dividends received from equity accounted investments – continuing operations		78	57
Dividends received from equity accounted investments – discontinued operations		-	88
Interest received		175	139
Purchases of property, plant and equipment		(307)	(419)
Purchases of intangible assets		(31)	(27)
Equity accounted investment funding		(4)	-
Proceeds from sale of property, plant and equipment		13	135
Proceeds from sale of investment property		53	174
Proceeds from sale of non-current other investments		15	1
Purchase of non-current other investments	15	(1)	(5)
Purchase of subsidiary undertakings	29,31	(1,731)	(12)
Net cash acquired with subsidiary undertakings		6	-
Purchase of equity accounted investments		(1)	(4)
Proceeds from sale of subsidiary undertakings	9	96	174
Cash and cash equivalents disposed of with subsidiary undertakings		(1)	(40)
Proceeds from sale of equity accounted investments	9	57	1,212
Proceeds from sale of Exchange Property	15	-	557
Net proceeds from sale/(purchase) of other deposits/securities		343	(468)
<b>Net cash (outflow)/inflow from investing activities</b>		<b>(1,240)</b>	<b>1,562</b>
Capital element of finance lease rental payments		(25)	(45)
Proceeds from issue of share capital	27	805	53
Purchase of treasury shares	27	(152)	(112)
Purchase of own shares	27	(50)	(12)
Equity dividends paid	30	(396)	(346)
Dividends paid to minority interests		(1)	-
Dividends paid on preference shares		(10)	(20)
Cash inflow from loans		-	66
Cash outflow from repayment of loans		(782)	(921)
<b>Net cash outflow from financing activities</b>		<b>(611)</b>	<b>(1,337)</b>
<b>Net (decrease)/increase in cash and cash equivalents</b>		<b>(31)</b>	<b>592</b>
Cash and cash equivalents at 1 January		3,074	2,491
Effect of foreign exchange rate changes on cash and cash equivalents		3	(9)
<b>Cash and cash equivalents at 31 December</b>		<b>3,046</b>	<b>3,074</b>
Comprising: Cash and cash equivalents		3,062	3,100
Overdrafts		(16)	(26)
<b>Cash and cash equivalents at 31 December</b>		<b>3,046</b>	<b>3,074</b>

# Consolidated statement of recognised income and expense

for the year ended 31 December

	Notes	2007 £m	2006 £m
Currency translation on foreign currency net investments:			
Subsidiaries		(1)	(162)
Equity accounted investments	14	43	(26)
Amounts credited to hedging reserve		41	221
Net actuarial gains on defined benefit pension schemes:			
Subsidiaries		544	692
Equity accounted investments		24	72
Fair value movements on available-for-sale investments		5	-
Current tax on items taken directly to equity	8	96	21
Deferred tax on items taken directly to equity:			
Subsidiaries	8	(259)	(227)
Tax rate adjustment <sup>1</sup>	8	(19)	-
Equity accounted investments		(6)	(92)
Recycling of fair value movements on disposal of available-for-sale investments		(6)	-
Recycling of cumulative currency translation on disposal:			
Continuing operations		-	3
Discontinued operations		-	11
Recycling of cumulative net hedging reserve on disposal – discontinued operations		-	(448)
<b>Net income recognised directly in equity</b>		<b>462</b>	<b>65</b>
<b>Profit for the year</b>		<b>922</b>	<b>1,639</b>
<b>Total recognised income and expense</b>		<b>1,384</b>	<b>1,704</b>
<b>Attributable to:</b>			
Equity shareholders		<b>1,363</b>	1,701
Minority interests		<b>21</b>	3
		<b>1,384</b>	<b>1,704</b>

<sup>1</sup> The UK current tax rate will be reduced from 30% to 28% with effect from 1 April 2008. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 30% to 28%, creating a rate adjustment, which is partly reflected in the Consolidated income statement and partly in the Consolidated statement of recognised income and expense.