Financial review

A year of continued growth

"These are another set of strong results. They demonstrate the significant fundamental strengths and quality of the business."

George Rose Finance Director

Results for the year – continuing operations

Sales[1] increased 14% from £13,765m to £15,710m. Sales in the full year from the Armor Holdings business, acquired in July 2007, were £725m. Like-for-like growth, after adjusting for the impact of exchange translations and acquisitions and disposals, was also 14%. US-led businesses were responsible for 47% of sales[1] and sales[1] generated from home markets represented 85% of the Group total.

EBITA[2] increased 22% to £1,477m (2006 £1,207m). The growth includes the benefit of five months trading from the Armor Holdings business, acquired in July 2007, which contributed EBITA[2] of £77m in the year. Translation of US$ generated results decreased EBITA[2] by £47m when compared with 2006. US-led businesses delivered 50% of the Group's EBITA[2].

Return on sales (EBITA[2] adjusted for uplift on acquired inventories expressed as a percentage of sales) for the Group increased from 8.8% to 9.5%.

Amortisation and impairment
The impairment charge of £148m includes £145m in respect of the goodwill associated with the Group's Insyte business.

Order book[1] increased to £38.6bn, primarily on the award of the Saudi Typhoon contract, MRAP orders and the acquisition of Armor Holdings.

Net finance costs[1]
Financial income, including the Group's share of the finance costs of equity accounted investments, was £93m (2006 £174m financial expense). The underlying net interest charge of £38m (2006 £157m) was offset by a net credit of £131m (2006 increased by a net charge of £17m) arising from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements.

Finance costs were reduced in 2007, primarily as a result of the benefit of the October 2006 Airbus net disposal proceeds (£1.2bn).

Underlying interest cover based on EBITA[2] increased from 7.7 times to 39 times.

Taxation
The Group's effective tax rate for continuing operations for the year was unchanged from 2006 at 26%.

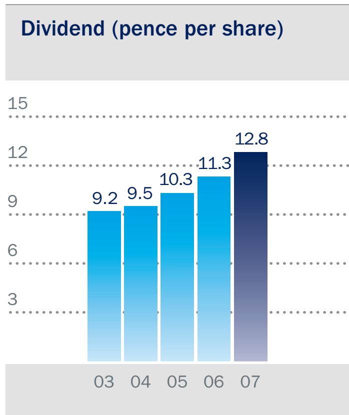
Earnings per share
Underlying earnings[3] per share from continuing operations for 2007 increased by 30% to 31.0p.

Basic earnings per share, in accordance with IAS 33 Earnings per Share, from continuing operations, increased by 31% to 26.0p (2006 19.9p).

Dividend
The Board is recommending a final dividend of 7.8p per share (2006 6.9p), bringing the total dividend for the year to 12.8p per share (2006 11.3p), an increase of 13.3%.

The proposed dividend is covered 2.4 times by earnings[3] from continuing operations (2006 2.1 times), which is consistent with the Group's policy of growing the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

Dividend (pence per share)



Summary income statement – continuing operations

	2007 £m	2006 £m
Sales[1]	**15,710**	13,765
EBITA[2]	**1,477**	1,207
Amortisation	**(149)**	(105)
Impairment	**(148)**	(34)
Net finance costs[1]	**93**	(174)
Taxation expense[1]	**(373)**	(248)
Profit for the year	**900**	646
Basic earnings per share	**26.0p**	19.9p
Underlying earnings[3] per share	**31.0p**	23.8p
Dividend per share	**12.8p**	11.3p

Business group summary

	2007				2006[5]			
	Sales[1] £m	EBITA[2] £m	Cash inflow[4] £m	Order book[1] £bn	Sales[1] £m	EBITA[2] £m	Cash inflow/ (outflow)[4] £m	Order book[1] £bn
Electronics, Intelligence & Support	**3,916**	**429**	**302**	**3.5**	4,007	429	273	3.4
Land & Armaments	**3,538**	**312**	**10**	**7.3**	2,115	168	137	4.9
Programmes & Support	**5,327**	**456**	**807**	**20.9**	4,615	342	449	17.0
International Businesses	**3,359**	**435**	**678**	**7.9**	3,428	415	171	7.1
HQ & Other Businesses	**243**	**(155)**	**181**	**0.4**	295	(147)	(225)	0.3
	16,383	**1,477**	**1,978**	**40.0**	14,460	1,207	805	32.7
Intra-group	**(673)**	**–**	**–**	**(1.4)**	(695)	–	–	(1.0)
Discontinued businesses	**–**	**–**	**–**	**–**	–	–	(23)	–
	15,710	**1,477**	**1,978**	**38.6**	13,765	1,207	782	31.7

1 including share of equity accounted investments
2 earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
3 earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and uplift on acquired inventories (see note 10 to the Group accounts)
4 net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
5 restated following changes to the Group's organisational structure

Financial review (continued)

Reconciliation of cash inflow from operating activities to net cash

	2007 £m	2006 £m
Cash inflow from operating activities	**2,162**	778
Capital expenditure (net) and financial investment	**(262)**	(141)
Dividends received from equity accounted investments	**78**	145
Operating business cash flow	**1,978**	782
Interest and preference dividends	**(65)**	(207)
Taxation	**(112)**	(85)
Free cash flow	**1,801**	490
Acquisitions and disposals	**(1,574)**	1,330
Debt acquired on acquisition of subsidiary	**(538)**	–
Issue/(purchase) of equity shares	**603**	(71)
Equity dividends paid	**(396)**	(346)
Dividends paid to minority interests	**(1)**	–
Preference share conversion	**245**	6
Other non-cash movements	**57**	(11)
Foreign exchange	**36**	323
Movement in cash on customers' account[6]	**32**	(9)
	265	1,712
Opening net cash/(debt) as defined by the Group	**435**	(1,277)
Closing net cash as defined by the Group	**700**	435
Analysed as:		
Term deposits – non-current	**–**	4
Term deposits – current	**164**	503
Cash and cash equivalents	**3,062**	3,100
Loans – non-current	**(2,197)**	(2,776)
Loans – current	**(283)**	(308)
Overdrafts – current	**(16)**	(26)
Loans and overdrafts – current	**(299)**	(334)
Cash on customers' account[6] (included within trade and other payables)	**(30)**	(62)
Closing net cash as defined by the Group	**700**	435

6 cash on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance

Cash flows

Cash inflow from operating activities was £2,162m (2006 £778m), which is after £76m (2006 £441m) special contributions to the UK pension schemes.

There was an outflow from net capital expenditure and financial investment of £262m (2006 £141m).

Dividends from equity accounted investments, primarily MBDA, Gripen International, Eurofighter and Saab, amounted to £78m.

The resulting operating business cash inflow of £1,978m (2006 £782m) gave rise to free cash inflow, after interest, preference dividends and taxation, of £1,801m (2006 £490m).

On 31 July 2007, the Group acquired Armor Holdings, Inc. for $4.5bn (£2.2bn) excluding fees. Net cash outflow from all acquisitions and disposals was £2,112m.

In the period, 33 million shares were purchased under the buyback programme announced in October 2006. The cash outflow in respect of this programme was £152m in the period. In May, £750m, before costs, was raised following the placing of new ordinary shares to part finance the proposed acquisition of Armor Holdings, Inc.

Conversion of the outstanding 260 million 7.75p (net) cumulative redeemable preference shares into ordinary shares removed the debt element of these preference shares, giving rise to an increase in reported cash of £245m.

The Group's net cash at 31 December 2007 was £700m, a net inflow of £265m from the net cash position of £435m at the start of the year.

Retirement benefit obligations

The movement in retirement benefit obligations during the year was as follows:

	£m
Deficit in defined benefit pension plans at 1 January 2007	(3,167)
Decrease in liabilities due to changes in assumptions	952
Actual return on assets below expected returns	(156)
One-off contributions	76
Recurring contributions over service cost	214
Transfers arising on acquisitions	(22)
Other movements	104
Deficit in defined benefit pension plans at 31 December 2007	(1,999)
US healthcare plans	(21)
Total IAS 19 deficit	(2,020)
Allocated to equity accounted investments and other participating employers	450
Group's share of IAS 19 deficit at 31 December 2007	(1,570)

Following higher regular contributions and an increase in real discount rates partly offset by lower than expected investment returns and the adoption of new mortality tables, the Group's share of the pension deficit decreased to £1,570m from £2,428m at 31 December 2006 after allocations to equity accounted investments and other participating employer companies.

A net deferred tax asset of £522m is disclosed in note 8 to the Group accounts relating to the above deficit.

Further disclosure on the above is provided in note 22 to the Group accounts.

Exchange rates

The principal exchange rates impacting the Group are as follows:

	2007	2006
£/€ – average	1.461	1.467
£/$ – average	2.002	1.844
£/€ – year end	1.361	1.484
£/$ – year end	1.988	1.957

Treasury policy

The Group's treasury activities are overseen by the Treasury Review Management Committee (TRMC). Two executive directors are members of the TRMC, including the Group Finance Director who chairs the Committee. The TRMC also has representatives with legal and taxation expertise.

The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the framework of treasury policies and guidelines approved by the Board. It is an overriding policy that trading in financial instruments for the purpose of profit generation is prohibited, with all financial instruments being used solely for risk management purposes.

Other key policies are:

- to maintain a balance between continuity of funding and flexibility through the use of borrowings with a range of maturities, currencies and fixed/floating rates of interest reflecting the Group risk profile;
- to maintain adequate undrawn committed borrowing facilities;
- to mitigate the exposure to interest rate fluctuations on borrowings and deposits by utilising interest rate swaps, interest rate options and forward rate agreements; and
- to hedge all material firm transactional exposures, unless otherwise approved as an exception by the TRMC, as well as to manage anticipated economic cash flows over the medium term.

Within this policy framework the treasury department's principal responsibilities are:

- to manage the Group's core funding and liquidity;
- to manage exposure to interest rate movements;
- to manage exposure to foreign currency movements;
- to control and monitor bank credit risk and credit capacity utilisation; and
- to manage the Group's relationship with debt capital market investors, banks and rating agencies.

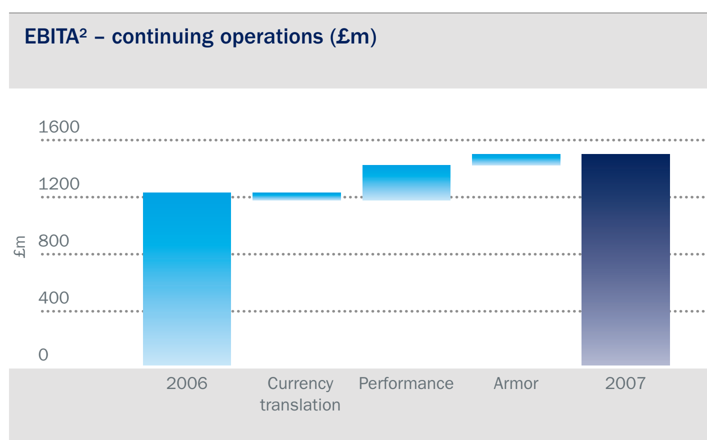
The treasury department transacts with an extensive range of counterparty banks and financial institutions, and adopts a systematic approach to the control and monitoring of counterparty credit risk. A credit limit is allocated to each counterparty with reference to its relevant credit rating. For internal credit risk purposes, all transactions are marked-to-market and the resultant exposure is allocated against the credit limit.

The Group, through its internal audit department, monitors compliance against the principal policies and guidelines (including the utilisation of credit) and any exceptions found are reported to the TRMC.

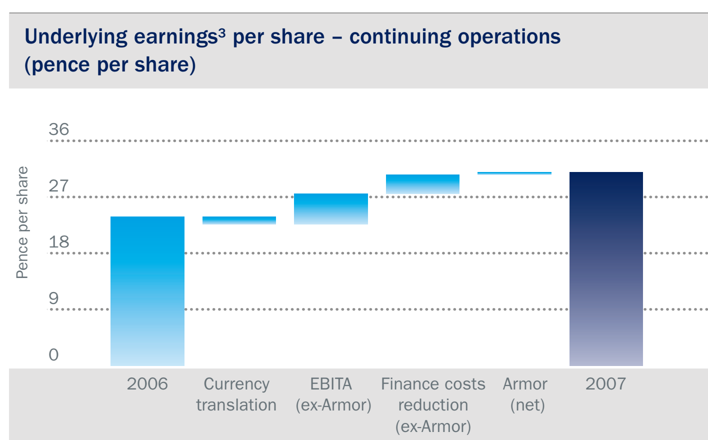
Further disclosure on financial instruments is set out in note 32 to the Group accounts.

The following charts illustrate the underlying performance of the Group, identifying separately the impact of currency and the acquisition of Armor Holdings.

EBITA[2] – continuing operations (£m)



Underlying earnings[3] per share – continuing operations (pence per share)



2 earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

3 earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and uplift on acquired inventories (see note 10 to the Group accounts)

Financial review (continued)

Capital structure

The Group funds its operations through a mixture of shareholders' funds and borrowing facilities, including bank and capital market borrowings. All the Group's material borrowings are arranged by the central treasury function and funds raised are lent onward to operating subsidiaries as required. The Group's objective is to ensure the continuity of competitively priced funding by borrowing from a range of markets and spreading the maturity dates of the various facilities.

Details of the Group's debt are included in note 20 to the Group accounts. During 2007, the US$200m Bond and the Eurofighter GmbH loans were repaid. No new long or medium-term debt was raised during the year. It remains the Group's intention to ensure the business is funded conservatively and to be proactive in accessing the bank and capital markets in achieving this aim.

Liquidity

Strong cash generation in recent years and a prudent financing strategy has resulted in the Group currently being well positioned to withstand the credit crisis in the bank and capital markets. The Group had cash and short-term investments at 31 December 2007 of £3,226m (2006 £3,603m). This, together with an undrawn committed Revolving Credit Facility (RCF) of £1.5bn (which is syndicated amongst the Group's core relationship banks), is available to meet any general corporate funding requirement. The RCF provides standby funding for the Group's US Commercial Paper programme which is not currently utilised. The RCF was contracted originally for five years until 2010. However, it has been extended by two one-year extension agreements until 2012, although the available amount for the final year has been reduced from £1.5bn to £1.3bn. The RCF remained undrawn throughout the year.

Since the start of the credit crisis in the summer of 2007, the Group has adopted a more conservative approach to the investment of its surplus cash, with money market deposits being placed with relatively stronger financial institutions for shorter periods. Bank counterparty credit risk is monitored closely on a systematic and ongoing basis, taking account of the size of the institution, its credit rating and its credit default swap price.

Generally, excluding the impact of acquisition or disposal financing, the net cash/debt of the Group is driven by operational performance, the level of receipts on the major contracts and the performance of the equity accounted investments. Historically, the net cash/debt position of the Group is usually at its best at the year end.

Insurance

The Group operates a policy of partial self-insurance, with the majority of cover placed in the external market. The Group continues to monitor its insurance arrangements to ensure the quality and adequacy of cover.

Credit rating

Three credit rating agencies, Moody's Investors Service, Standard and Poor's Ratings Services and Fitch's Investors Service, publish credit ratings for the Group. During the year Standard & Poor's improved their rating to BBB+ and all three maintained the outlook for their rating as stable.

As at 31 December 2007, the Group's long-term credit ratings provided by these agencies were as follows:

Rating agency	Rating	Outlook	Category
Moody's	Baa2	Stable	Investment grade
Standard & Poor's	BBB+	Stable	Investment grade
Fitch	BBB	Stable	Investment grade

The Board continues to view the maintenance of an investment grade credit rating as important to the efficient operation of the Group's activities.

Critical accounting policies

The Group's significant accounting policies are outlined in note 1 to the Group accounts (page 94). Not all of these significant accounting policies require management to make difficult, subjective or complex judgements or estimates.

The following is intended to provide an understanding of those policies that management considers critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements. These judgements involve assumptions or estimates in respect of future events, which can vary from what is anticipated. However, the directors believe that the consolidated financial statements reflect appropriate judgements and estimations and provide a true and fair view of our financial performance and position over the relevant period.

Contract revenue and profit recognition

The majority of the Group's defence activities are conducted under long-term contract arrangements and are accounted for in accordance with International Accounting Standard 11 Construction Contracts (IAS 11). Revenue is recognised on such contracts based on the achievement of performance milestones. No profit is recognised on contracts until the outcome of the contract can be reliably estimated.

Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowance for technical and other risks related to performance milestones yet to be achieved.

Owing to the complexity of many of the contracts undertaken by the Group the cost estimation process requires significant judgement and is based upon the knowledge and experience of the Group's project managers, engineers, finance and commercial professionals and using the Group's contract management processes. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the contract include the nature and complexity of the work to be performed, availability and productivity of labour, the effect of change orders, the availability of materials, performance of subcontractors and availability and access to government-furnished equipment.

Cost and revenue estimates and judgements are reviewed and updated at least quarterly and more frequently as determined by events or circumstances. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense. Contract costs comprise directly attributable costs including an allocation of direct overheads. Indirect overheads are only regarded as contract costs when their recovery is explicitly allowed for under the terms of the contract. Indirect costs are otherwise treated as a period cost and are expensed as incurred. Material changes in one or more of these estimates, whilst not anticipated, would affect the profitability of individual contracts.

Where goods are supplied under arrangements not considered to represent Construction Contracts, as defined by IAS 11, sales are recognised when the significant risks and rewards of ownership have been transferred and the related revenue and costs can be measured reliably.

Where services are rendered, sales are recognised when the stage of completion of the services and the related revenue and costs can be measured reliably.

Additional details concerning the Group's revenue recognition policy are in note 1 to the Group accounts.

Retirement benefit plans

The Group accounts for post-retirement pension and healthcare plans in accordance with IAS 19 Employee Benefits (IAS 19).

For defined benefit retirement plans, 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. Actuarial gains and losses are recognised in full in the period in which they occur and are recognised in the statement of recognised income and expense. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is amortised on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligations recognised in the balance sheet represent the present value of the defined benefit obligation as adjusted for unrecognised past service cost and as reduced by the fair value of plan assets.

The main assumptions made in accounting for the Group's post-retirement plans relate to the expected return on investments within the Group's plans, the rate of increase in pensionable salaries, the rate of increase in the retail price index, the mortality rate of plan members and the discount rate applied in discounting liabilities. For each of these assumptions there is a range of possible values and, in consultation with our actuaries, management decides the point within that range that most appropriately reflects the Group's circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit calculated under IAS 19.

The Group has allocated an appropriate share of the pension deficit to its equity accounted investments and to other participating employers using a consistent and reasonable method of allocation which represents, based on current circumstances, the directors' best estimate of the proportion of the deficit anticipated to be funded by these entities. The Group's share of the pension deficit allocated to the equity accounted investments is included on the balance sheet within equity accounted investments.

Financial review (continued)

The valuing of assets and liabilities at a point in time rather than matching expectations of assets and liabilities over time has no impact on short-term cash contributions to the pension plans. These funding requirements are derived from separate independent actuarial valuations.

Additional details concerning the Group's retirement benefit plans are given in note 1 and note 22 to the Group accounts.

Intangible assets

In accordance with International Financial Reporting Standard 3 Business Combinations (IFRS 3), goodwill arising on acquisition of subsidiaries is capitalised and included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in equity accounted investments. IFRS 3 also requires the identification of other acquired intangible assets. The techniques used to value these intangible assets are in line with internationally used models but do require the use of estimates which may differ from actual outcomes. Future results are impacted by the amortisation period adopted for these items and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.

Goodwill is not amortised but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review calculations require the use of estimates related to the future profitability and cash-generating ability of the acquired business. Additional details concerning the Group's treatment of intangible assets and impairment reviews are given in note 1 to the Group accounts.

Regional Aircraft valuations

The Group holds a number of regional aircraft on its balance sheet. These aircraft are leased to airline operators. In addition, the Group has provided residual value guarantees (RVGs) in respect of certain regional aircraft sold. The aircraft held on balance sheet are subject to regular impairment testing. During the year the anticipated aircraft values were reassessed to a value based on their contracted rental inflows plus a residual value determined by the aircraft type and age. Provisions related to the RVGs are measured as the difference between amounts payable to customers and the estimated fair value of the aircraft. The estimated fair value of those aircraft is made on the same basis as for the aircraft held on balance sheet.

Much of the leasing business was underpinned by the Group's Financial Risk Insurance Programme, which makes good shortfalls in actual lease income against originally estimated future income for a 15-year period from 1998 to 2013. Since 2006, BAE Systems and certain of the reinsurers have been in dispute over several areas of the policy. During 2007, agreement was reached with almost all the reinsurers and settlements have been paid by them based on the net present value of estimated future claims. Arbitration proceedings now continue with only one reinsurer. Additional details concerning these arrangements are contained in the Risk management and principal risks section on page 49 of this report.

The Group has granted RVGs in respect of certain aircraft sold of which £134m remains outstanding (2006 £191m). It is considered that the Group's net exposure to these guarantees is covered by the provisions held, on a net present value basis, and the estimated residual values of those aircraft. Additional details concerning this are given in note 24 to the Group accounts.