

1. Accounting policies

Basis of preparation

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss, and in accordance with applicable accounting standards in the United Kingdom (UK GAAP). The going concern basis has been applied in these accounts.

In the Company's accounts, all fixed asset investments (including subsidiary undertakings and joint ventures) are stated at cost (or valuation in respect of certain listed investments) less provisions for impairments. Dividends received and receivable are credited to the Company's profit and loss account. In accordance with Section 230(4) of the Companies Act 1985 the Company is exempt from the requirement to present its own profit and loss account. The amount of profit for the financial year of the Company is disclosed in note 14 to these accounts.

Relief under Sections 131 and 133 of the Companies Act 1985 is taken wherever possible. Accordingly, where such relief is available, the difference between the fair value and aggregate nominal value of shares is not recognised in either shareholders' funds or cost of investment.

Changes in accounting policies

Financial Reporting Standard 29 Financial Instruments: Disclosures (FRS 29) is applicable to the Company for the year ended 31 December 2007. The Company is exempt from presenting FRS 29 disclosures as full equivalent disclosures are presented on a Group basis within the consolidated financial statements.

Urgent Issues Task Force (UITF) Abstract 41 Scope of FRS 20 is applicable to the Company for the year ended 31 December 2007. This does not have any significant impact on the Company's accounts.

UITF Abstract 44 FRS 20, Group and treasury share transactions will be applicable for the year ending 31 December 2008. It is not expected to have any significant impact on the Company's accounts.

Cash flow statement

The Company is exempt under the terms of Financial Reporting Standard 1 from the requirement to publish its own cash flow statement, as its cash flows are included within the consolidated cash flow statement of the Group.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. 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 profit and loss account unless they qualify for hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

Tangible fixed assets

Depreciation is provided, normally on a straight-line basis, to write off the cost or valuation of tangible fixed assets over their estimated useful economic lives to any estimated residual value using the following rates:

Buildings	up to 50 years, or the lease term if shorter
Computing equipment, motor vehicles and short life works equipment	3 to 5 years

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

Impairment reviews are undertaken if there are indications that the carrying values may not be recoverable.

Leases

Assets obtained under finance leases are included in tangible fixed assets at cost and are depreciated over their useful economic lives, or the term of their lease, whichever is shorter. Future instalments under such leases, net of finance charges, are included within loans. Rental payments are apportioned between the finance element, which is charged as interest to the profit and loss account, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant rate of charge on the outstanding obligation.

Rental payments under operating leases are charged to the profit and loss account on a straight-line basis in arriving at operating profit.

Investments

The Company's investment in shares in group companies are stated at cost less provision for impairment.

Stocks

Stocks are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

Tax

The charge for taxation is based on the profit for the year and takes account of taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Deferred tax is recognised on an undiscounted basis in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date where there is an obligation to pay more tax, or a right to pay less tax, in the future.

Pensions and other post-retirement benefits

The Company contributes to Group pension plans operated in the UK. Details of the principal plans and the financial assumptions used are contained in the consolidated accounts of BAE Systems plc. As permitted by Financial Reporting Standard 17 Retirement Benefits, the plans are accounted for as defined contribution plans, as the employer cannot identify its share of the underlying assets and liabilities of the plans. The employer's contributions are set in relation to the current service period and also to fund a series of agreed measures to address the pension scheme deficits.

1. Accounting policies (continued)

Share options and own shares held

The Company issues equity-settled share options to Group employees. In accordance with the requirements of FRS 20 Share-based payment (FRS 20), the Company has applied FRS 20 to all equity-share options granted after 7 November 2002 that were unvested as of 1 January 2005. Equity-settled share options 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.

In accordance with UITF Abstract 25 National insurance contributions on share option gains the Company provides in full for the employer's national insurance liability estimated to arise on the future exercise of share options granted, except where the employee has agreed to settle the employer's national insurance liability as a condition of the grant of the options.

As required under UITF Abstract 38 Accounting for ESOP trusts the cost to the Company of own shares held is shown as a deduction from shareholders' funds within the profit and loss account. Consideration paid or received for the purchase or sale of the Company's own shares in the ESOP trust is shown separately in the reconciliation of movements in shareholders' funds.

Preference share capital

During the year, the Company's 7.75p (net) cumulative preference shares of 25p each were converted into the Company's ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for every preference share.

In accordance with FRS 25 Financial Instruments: Disclosure and Presentation the preference shares were considered a compound financial instrument and, accordingly, split into an underlying debt instrument, classified within loans and overdrafts, and an equity conversion option, classified within equity.

The underlying debt instrument was presented on an amortised cost basis until extinguished on conversion.

The equity conversion option was presented at its historic fair value, based on the date of original issue of the preference shares. On conversion of the preference shares into ordinary shares, the equity component was reclassified to share capital and share premium.

Dividends thereon are recognised in the profit and loss account as finance costs.

Dividends

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

Notes to the Company accounts (continued)

2. Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	Total £m
Cost			
At 1 January 2007	14	40	54
Disposals	(5)	(13)	(18)
At 31 December 2007	9	27	36

Depreciation and impairment

At 1 January 2007	10	35	45
Depreciation	–	2	2
Disposals	(4)	(13)	(17)
At 31 December 2007	6	24	30

Net book value

At 31 December 2007	3	3	6
At 31 December 2006	4	5	9

The amounts above at 31 December 2007 include:

	Land and buildings £m	Plant and equipment £m	Total £m
Capitalised finance leases			
Cost	–	24	24
Accumulated depreciation	–	24	24

Assets let under operating leases

Cost	–	–	–
Accumulated depreciation	–	–	–

Net book value of:

Long leasehold property	3	–	3
Fixtures, fittings and equipment	–	3	3
	3	3	6

Land and buildings comprise:

- freehold and long leasehold land and buildings owned by the Company as at 30 June 1996, excluding certain overseas properties, revalued at that date. The majority of the Group's operational properties at that time were valued on a depreciated replacement basis, owing to their specialisation, with the remainder on an existing use value basis. Other non-operational properties were valued on the basis of open market value;
- short leaseholds at cost;
- additions subsequent to 30 June 1996 at cost; and
- land and buildings owned by subsidiary undertakings acquired since 30 June 1996 at fair value at the date of acquisition.

3. Fixed asset investments

	Subsidiary undertakings £m	Other £m	Total £m
Cost			
At 1 January 2007	5,042	–	5,042
Additions	617	1	618
Disposals	–	(7)	(7)
Fair value movements	–	6	6
At 31 December 2007	5,659	–	5,659

Impairment provisions

At 1 January 2007 and 31 December 2007	64	(1)	63
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Net carrying value

At 31 December 2007	5,595	1	5,596
At 31 December 2006	4,978	1	4,979

4. Stocks

	2007 £m	2006 £m
Development properties	-	2

5. Debtors

	2007 £m	2006 £m
Due within one year		
Corporation tax recoverable	34	32
Amounts owed by subsidiary undertakings	7,580	4,500
Amounts owed by Group joint ventures	3	1
Other debtors	23	33
Prepayments and accrued income	30	33
	7,670	4,599
Due after one year		
Other debtors	116	143
Prepayments and accrued income	-	1
	116	144

Other debtors includes cash collateral of £109m (2006 £115m).

6. Current asset investments

	2007 £m	2006 £m
Other securities	130	491

7. Other financial assets and liabilities

	2007 Assets £m	2007 Liabilities £m	2006 Assets £m	2006 Liabilities £m
Due within one year				
Cash flow hedges – foreign exchange contracts	62	(41)	31	(36)
Other foreign exchange/interest rate contracts	77	(88)	51	(51)
	139	(129)	82	(87)
Due after one year				
Cash flow hedges – foreign exchange contracts	34	(20)	30	(42)
Other foreign exchange/interest rate contracts	29	(37)	55	(34)
	63	(57)	85	(76)

Full disclosures relating to the Group's other financial assets and liabilities and financial risk management strategies are given in the Financial review section of the Directors' report and note 32 to the Group accounts.

Notes to the Company accounts (continued)

8. Loans and overdrafts

	2007 £m	2006 £m
Due within one year		
Bank loans and overdrafts	15	85
Euro-Sterling £150m 11 $\frac{3}{4}$ % bond, repayable 2008	150	–
European Investment Bank loans, final instalment 2009	7	7
Debt-related financial instruments	–	19
SYSTEMS 2001 Asset Trust:		
Option Aircraft bond	16	12
	188	123
Due after one year		
Euro-Sterling £150m 11 $\frac{3}{4}$ % bond, repayable 2008	–	150
European Investment Bank loan, final instalment 2009	4	11
Euro-Sterling £100m 10 $\frac{3}{4}$ % bond, repayable 2014	99	99
SYSTEMS 2001 Asset Trust:		
Option Aircraft bond, final instalment 2013	153	192
Debt instrument of the convertible preference shares, redeemable 2010	–	242
Debt-related financial instruments	191	217
Alvis loan notes, redeemable 2009	1	2
	448	913

Bank loans and overdrafts are at a floating rate of interest.

The European Investment Bank borrowing is fixed with an interest rate of 6.86%.

The SYSTEMS 2001 Asset Trust bonds are at a floating rate of interest, having been converted to a sterling floating rate bond by utilising a cross-currency swap which resulted in an effective interest rate during 2007 of 6.75% (2006 5.59%).

Loans and overdrafts are repayable as follows:

	2007 £m	2006 £m
In one year or less	188	123
Between one and two years	26	180
Between two and five years	87	317
In later years	335	416
	636	1,036

The total amount of loans repayable by instalments, where any instalment is due after five years, is £169m (2006 £203m).

9. Creditors

	2007 £m	2006 £m
Due within one year		
Amounts owed to subsidiary undertakings	10,584	8,125
Amounts owed to Group joint ventures	844	605
Other creditors	141	134
Accruals and deferred income	38	39
	11,607	8,903
Due after one year		
Other creditors	9	1
	9	1

10. Provisions for liabilities and charges

	Contracts and other £m
At 1 January 2007	12
Created	63
Utilised	(5)
At 31 December 2007	70

Provisions created mainly relate to onerous property leases.

11. Contingent liabilities and commitments

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £1,981m (2006 £2,182m) which are included in the Group's borrowings have been guaranteed by the Company.

12. Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		Nominal value £m
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	
Authorised					
At 1 January 2007 and 31 December 2007	4,450	111	1	1	111
Issued and fully paid					
At 1 January 2006	3,219	80	1	1	80
Exercise of options	24	1	–	–	1
Conversion of preference shares	3	–	–	–	–
At 1 January 2007	3,246	81	1	1	81
Exercise of options	29	1	–	–	1
Placing of shares	174	5	–	–	5
Conversion of preference shares	125	3	–	–	3
At 31 December 2007	3,574	90	1	1	90

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Enterprise and Regulatory Reform (formerly the Secretary of State for Trade and Industry) (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Placing of shares

On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were placed at a price of 430p, raising £750m before expenses.

Conversion of preference shares

As at 1 January 2007, the Company also had in issue 259,962,909 7.75p (net) cumulative redeemable preference shares of 25p each. During the year, the shares were converted into ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for each preference share, as a result of which 124,532,630 ordinary shares of 2.5p were issued. There were, therefore, no preference shares in issue as at 31 December 2007.

In accordance with FRS 25 the convertible preference shares were considered to be a compound financial instrument consisting of both a debt element and an equity component which required separate accounting treatment. Following conversion to ordinary shares the amounts previously recognised within equity and within loans and overdrafts have been extinguished.

Treasury shares

In connection with the disposal of its interest in Airbus, the Company stated its intention to return up to £500m to ordinary shareholders by way of on-market purchases of ordinary shares using authorities granted at the 2006 AGM and to hold the repurchased shares initially in treasury. The Company commenced this buyback programme on 26 October 2006 and, as at 31 December 2007, 61,945,000 (2006 28,675,000) 2.5p ordinary shares with an aggregate nominal value of £2m (2006 £1m) were held in treasury.

Notes to the Company accounts (continued)

13. Employee share schemes

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various schemes. Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 64 to 83 of this report.

	Executive Share Option Scheme				Save-As-You-Earn			
	2007		2006		2007		2006	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	27,513	2.84	36,141	2.77	654	1.78	1,027	1.88
Granted during the year	2,994	4.59	2,886	4.28	-	-	-	-
Exercised during the year	(9,840)	2.31	(3,864)	2.30	(351)	2.23	(248)	2.58
Expired during the year	(5,621)	3.34	(7,650)	3.32	(7)	1.44	(125)	1.09
Outstanding at the end of the year	15,046	3.35	27,513	2.84	296	1.25	654	1.78
Weighted average remaining life (years)		7		6		1		2
Weighted average fair value of options granted (£)		1.47		1.30		-		-
Range of exercise price of outstanding options (£)		1.72 - 4.87		1.72 - 4.87		0.93 - 2.57		0.93 - 2.57
Expense recognised for the year (£m)		4		4		-		-

	Share Matching Plan	Performance Share Plan		Restricted Share Plan	
	2007 Number of shares '000	2007 Number of shares '000	2006 Number of shares '000	2007 Number of shares '000	2006 Number of shares '000
Outstanding at the beginning of the year	-	12,197	11,471	882	826
Granted during the year	281	1,996	1,924	-	119
Exercised during the year	-	(3,742)	(944)	(508)	(9)
Expired during the year	(1)	(577)	(254)	(23)	(54)
Outstanding at the end of the year	280	9,874	12,197	351	882
Weighted average remaining life (years)	2	4	5	-	1
Weighted average fair value of options granted (£)	4.59	2.31	1.88	-	3.89
Expense recognised for the year (£m)	-	3	4	-	1

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2006 £nil).

Information on options granted in the year can be found on page 126 (note 26 to the Group accounts).

14. Reserves

	Share premium account £m	Other reserves £m	Profit and loss account £m
At 31 December 2006	841	101	1,689
Profit for the year	-	-	92
Dividends paid	-	-	(396)
Share placing (net of costs)	-	-	736
Share-based payments	-	-	34
Exercise of options	63	-	-
Purchase of own shares	-	-	(50)
Conversion of preference shares	318	-	-
Purchase of treasury shares	-	-	(152)
Other movements	-	-	(13)
Fair value movements on available-for-sale investments	-	-	6
Recycling of fair value movements on disposal of available-for-sale investments	-	-	(6)
Movements in hedging reserve	-	17	-
At 31 December 2007	1,222	118	1,940

14. Reserves (continued)

Other reserves

Other reserves for the Company comprise: capital reserve £24m (2006 £24m); hedging reserve £8m credit (2006 £9m debit); and non-distributable reserve arising from property disposals to other Group undertakings £86m (2006 £86m). The non-distributable reserve arising from property disposals to other Group undertakings relates to the revaluation surplus realised by the Company on properties which were sold to other Group companies as part of operational reorganisations in prior years. Amounts within this reserve will be transferred to the profit and loss account as distributable when the related properties are disposed of outside the Group, or written down following impairment.

Placing of shares

On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were issued by a placing of shares. The placing structure utilised attracted merger relief under Section 131 of the Companies Act 1985, resulting in a credit to the merger reserve of £736m. Subsequent internal transactions required to complete the placing structure have resulted in this part of the merger reserve being transferred to the retained earnings reserve.

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

Conversion of preference shares

During the year, 259,962,909 (2006 6,116,123) preference shares were converted into ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for each preference share.

Treasury shares

During the year, 33,270,000 ordinary shares of 2.5p each were repurchased under the buyback programme announced in October 2006. As at 31 December 2007, 61,945,000 (2006 28,675,000) 2.5p ordinary shares with an aggregate nominal value of £2m (2006 £1m) were held in treasury.

BAE Systems ESOP Trust

The Company has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividend paid in November 2007.

At 31 December 2007, the ESOP held 1,552,015 (2006 2,382,835) 2.5p ordinary shares with a market value of £8m (2006 £10m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver is also in operation over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

Company profit

The Company's profit for the financial year was £92m (2006 £1,617m).

15. Statutory reserve

Under Section 4 of the British Aerospace Act 1980 this reserve may only be applied in paying up unissued shares of the Company to be allotted to members of the Company as fully paid bonus shares.

16. Other information

Employees

The total number of employees of the Company at 31 December 2007 was 520 (2006 596). Total staff costs, excluding charges for share options, were £68m (2006 £67m).

Total directors' emoluments, excluding company pension contributions, were £8,580,000 (2006 £9,647,000). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company.

Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,111,000 (2006 £1,023,000).