

1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

Basis of preparation

The consolidated financial statements of BAE Systems plc have been prepared in accordance with EU endorsed International Financial Reporting Standards (IFRS), International Financial Reporting Interpretations Committee interpretations (IFRICs) and the Companies Act 1985 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates and judgements. An analysis and explanation of the critical accounting estimates and judgements used in producing this set of financial statements is made in the Directors' report on pages 23 and 24.

Basis of consolidation

The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' and associates' results accounted for under the equity method, all of which are prepared to 31 December.

A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of the entity so as to obtain benefits from its activities. Subsidiaries include the special purpose entities that the Group transacted through for the provision of guarantees in respect of residual values and head lease and finance payments on certain regional aircraft sold.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. The results of such subsidiaries are included in the consolidated income statement from the date of acquisition, up to the date of disposal.

An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. An entity is regarded as an associate if the Group has significant influence, but not control, over its operating and financial policies. Joint ventures and associates are accounted for under the equity method where the Group's income statement includes its share of their profits and losses and the Group's balance sheet includes its share of their net assets.

Where the Group contributes a business, or other non-monetary assets for an interest in a subsidiary, joint venture or associate, such transactions are recorded so that the reduction in ownership of the business being contributed is accounted for as a disposal while the increased interest in the enlarged Group or new interest in the business contributed by other parties to the transaction is accounted for as an acquisition. Fair values are applied to those operations which are subject to the exchange and which have not previously been held within the Group. Any loss or realised gain resulting from the transaction is recorded in the income statement while any unrealised gain is eliminated against the investment.

Goodwill

Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing.

Goodwill arising on acquisitions before the date of transition to IFRS (1 January 2004) has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entity if it had applied IAS 38 Intangible Assets at the date it was acquired by the Group were considered immaterial, after being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Impairment

The carrying amounts of the Group'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 intangible assets that are not yet available for use, and goodwill, the recoverable amount is estimated at each balance sheet date.

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 of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates. Receivables with a short-term duration are not discounted.

The recoverable amount of other assets is the greater of their fair value less cost 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.

These calculations use cash flow projections based on the Group's Integrated Business Plan and include a terminal value based on the projections for the final year of that plan. This is considered appropriate due to the long-term nature of the defence industry. A pre-tax discount rate of 8.43% has been used in discounting the projected pre-tax cash flows.

For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised. An impairment loss in respect of an equity investment classified as available-for-sale is not reversed through profit or loss. An impairment loss in respect of goodwill is not reversed. An impairment loss in respect of other assets is reversed 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.

1. Accounting policies (continued)

Revenue and profit recognition

Sales include the Group's net share of sales of joint ventures and associates. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of joint ventures and associates.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11 Construction Contracts. Sales are recognised as soon as the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

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 allowances for technical and other risks related to performance milestones yet to be achieved. The amount of profit attributable to the stage of completion of these contracts is arrived at by reference to the estimated overall profitability of the contract. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered

Sales of goods and the provision of services not under a long-term contract are recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer and revenue and costs can be reliably measured.

Profit is recognised at the time of sale. Sales and profits on intercompany trading are generally determined on an arm's length basis.

Lease income

Rental income from aircraft operating leases is recognised in revenue on a straight-line basis.

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 consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes, is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses. Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy above.

Other intangible assets

Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing or maintaining computer software programmes for sale is recognised as an expense as incurred.

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses.

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing.

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of the intangible assets.

The estimated useful lives are as follows:

Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Trademarks and licences	up to 20 years
Other intangibles	up to 10 years

Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

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
Research equipment	8 years
Computing equipment, motor vehicles and short life works equipment	3 to 5 years
Aircraft	up to 15 years, or the lease term if shorter
Other equipment	10 to 15 years, or the project life if shorter

In the Group's North American businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

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

1. Accounting policies (continued)

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

Investment property

Land and buildings that are leased to non-group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

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.

Other investments

The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

- (a) loans and receivables: term deposits, principally comprising funds held with banks and other financial institutions, are carried at amortised cost using the effective interest method;
- (b) at fair value through profit or loss: financial instruments held for trading or designated by management on initial recognition. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date;
- (c) held to maturity: non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity. During the year, the Group did not hold any investments in this category;
- (d) available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date.

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as at fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

Trade and other receivables

Trade and other receivables are stated at their amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired.

Amounts due from customers for contract work include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

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

Cash received on customers' account is excluded from net cash/(debt) as defined by the Group.

Inventories

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

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call 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. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

Non-current assets and disposal groups held for sale

Non-current assets and disposal groups are classified as assets held for sale and stated at the lower of carrying amount and fair value less costs to sell if their carrying amount is to be recovered principally through a sale transaction rather than through continuing use.

This condition is regarded as met only when the sale is highly probable and expected to be completed within a year from the classification. In addition, the asset (or disposal group) is to be available for immediate sale in its present condition and is actively being marketed at a price that is reasonable in relation to its current fair value.

Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Borrowing costs

Borrowing costs in connection with the acquisition or construction of items of property, plant and equipment, investment property and inventories are not capitalised.

Trade and other payables

Trade and other payables are stated at their cost.

1. Accounting policies (continued)

Leases

Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

Payments, including any incentives, made under operating leases are recognised in the income statement on a straight-line basis over the lease term.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

Derivative financial instruments

The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

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. Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised directly in reserves. Amounts recognised in reserves are recycled from reserves 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. Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability, and gains and losses on the derivative instrument, are recognised in the income statement for the period. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement for the period.

Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Provisions

A provision is recognised in the balance sheet when the Group 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.

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 all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

1. Accounting policies (continued)

Employee benefits – Pension obligations

Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

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 recognised 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 obligations as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets.

Long-term service benefits – Equity and equity-related compensation benefits

The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2 Share-based Payments (IFRS 2), the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 26, 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 Group's estimate of the number of shares that will actually vest.

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

Preference share capital

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

In accordance with IAS 32 Financial Instruments: 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 income statement as finance costs.

Dividends

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

2. Changes in accounting policies

Standards, amendments and interpretations effective in 2007

With effect from 1 January 2007 the Group has adopted IFRS 7, Financial Instruments: Disclosures. This introduces new disclosures for financial instruments, but does not have any impact on the consolidated income statement or balance sheet.

The following amendments and interpretations to published standards are effective for accounting periods beginning on or after 1 January 2007:

- IFRIC 7, Applying the restatement approach under IAS 29;
- IFRIC 8, Scope of IFRS 2;
- IFRIC 9, Reassessment of embedded derivatives;
- IFRIC 10, Interim financial reporting and impairment; and
- Amendment to IAS 1, Presentation of financial statements – capital disclosures.

None of these have any significant impact on the Group's accounts.

New standards and interpretations to existing standards that are not yet effective and have not been early adopted by the Group

The following EU endorsed standards and interpretations to existing standards have been published and are mandatory for the Group's accounting period beginning on 1 January 2008 or later periods but have not been early adopted by the Group:

- IFRS 8, Operating Segments (effective for 2009). This requires that entities adopt the 'management approach' to reporting the financial performance of their operating segments. The standard is concerned with disclosure only and will therefore have no impact on the consolidated income statement or balance sheet. Following the changes to the Group's organisational structure from 1 January 2007, it is not expected to have a significant disclosure impact;
- IFRIC 11, IFRS 2, Group and Treasury Share Transactions is effective for 2008. It is not expected to have any significant impact on the Group's accounts; and
- IFRIC 14, IAS 19, The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction is effective for 2008. The interpretation aims to clarify how to determine in normal circumstances the limit on the asset that an employer's balance sheet may contain in respect of its defined benefit pension plans and when additional liabilities might be required to be recognised. This is not expected to have any significant impact on the Group's accounts.

3. Segmental analysis

Analysis by business group

	Combined sales of Group and equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	Restated ¹		Restated ¹		Restated ¹		Restated ¹	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Electronics, Intelligence & Support	3,916	4,007	(7)	(10)	-	-	3,909	3,997
Land & Armaments	3,538	2,115	(1)	(4)	-	1	3,537	2,112
Programmes & Support	5,327	4,615	(1,367)	(1,522)	1,111	1,255	5,071	4,348
International Businesses	3,359	3,428	(1,307)	(1,321)	-	-	2,052	2,107
HQ & Other Businesses	243	295	-	(8)	-	-	243	287
	16,383	14,460	(2,682)	(2,865)	1,111	1,256	14,812	12,851
Intra-business group sales/revenue	(673)	(695)	-	-	170	177	(503)	(518)
	15,710	13,765	(2,682)	(2,865)	1,281	1,433	14,309	12,333

	Intra-business group revenue		Revenue from external customers	
	Restated ¹		Restated ¹	
	2007 £m	2006 £m	2007 £m	2006 £m
Electronics, Intelligence & Support	97	92	3,812	3,905
Land & Armaments	11	14	3,526	2,098
Programmes & Support	361	377	4,710	3,971
International Businesses	10	14	2,042	2,093
HQ & Other Businesses	24	21	219	266
	503	518	14,309	12,333

	EBITA ²		Amortisation of intangible assets		Impairment of intangible assets		Business group result ³	
	Restated ¹		Restated ¹		Restated ¹		Restated ¹	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Electronics, Intelligence & Support	429	429	(15)	(14)	-	(2)	414	413
Land & Armaments	312	168	(110)	(66)	-	-	202	102
Programmes & Support	456	342	(19)	(20)	(145)	-	292	322
International Businesses	435	415	(4)	(4)	-	-	431	411
HQ & Other Businesses	(155)	(147)	(1)	(1)	(3)	(32)	(159)	(180)
	1,477	1,207	(149)	(105)	(148)	(34)	1,180	1,068
Financial income of equity accounted investments							35	21
Taxation expense of equity accounted investments							(38)	(35)
Operating profit							1,177	1,054
Finance costs							58	(195)
Profit before taxation							1,235	859
Taxation expense							(335)	(213)
Profit for the year from continuing operations							900	646

1 restated following changes to the Group's organisational structure

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

3 the analysis by business group of the share of results of equity accounted investments is provided in note 14

Notes to the Group accounts (continued)

3. Segmental analysis (continued)

	Assets excluding intangible assets and equity accounted investments		Intangible assets		Equity accounted investments		Total assets		Total liabilities	
	Restated ¹		Restated ¹		Restated ¹		Restated ¹		Restated ¹	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Electronics, Intelligence & Support	1,406	1,360	4,491	4,591	3	13	5,900	5,964	(1,164)	(1,117)
Land & Armaments	1,510	697	4,435	2,208	-	1	5,945	2,906	(1,191)	(787)
Programmes & Support	1,035	1,178	575	731	45	58	1,655	1,967	(3,696)	(3,431)
International Businesses	1,106	677	27	31	733	599	1,866	1,307	(1,778)	(1,159)
HQ & Other Businesses	882	1,211	31	34	-	-	913	1,245	(1,705)	(1,416)
	5,939	5,123	9,559	7,595	781	671	16,279	13,389	(9,534)	(7,910)
Disposal groups held for sale (note 19)							94	-	(30)	-
Tax							602	1,080	(539)	(432)
Retirement benefit obligations							59	71	(1,629)	(2,499)
Cash/(debt) as defined by the Group (note 29)							3,226	3,607	(2,526)	(3,172)
Consolidated total assets/(liabilities)							20,260	18,147	(14,258)	(14,013)

	Capital expenditure ²		Depreciation and amortisation ²	
	Restated ¹		Restated ¹	
	2007 £m	2006 £m	2007 £m	2006 £m
Electronics, Intelligence & Support	92	107	84	89
Land & Armaments	82	47	144	94
Programmes & Support	77	84	110	93
International Businesses	60	176	18	10
HQ & Other Businesses	30	124	51	49
	341	538	407	335

Analysis by geographical location

	Customer location				Asset location			
	Sales ³		Revenue		Carrying value of segment assets		Capital expenditure ²	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
United Kingdom	3,433	2,802	3,179	2,580	3,319	3,544	102	165
Rest of Europe	2,611	2,704	1,750	1,806	1,360	1,197	25	66
Middle East	2,061	1,993	1,927	1,827	485	470	52	169
United States and Canada	6,383	5,402	6,333	5,372	10,936	7,987	150	131
Asia and Pacific	978	595	930	532	106	104	7	4
Africa, Central and South America	244	269	190	216	73	87	5	3
	15,710	13,765	14,309	12,333	16,279	13,389	341	538

Analysis of revenue by category

	2007 £m	2006 £m
Sale of goods	4,559	3,775
Construction contracts	7,611	6,558
Services	2,070	1,921
Lease income	63	66
Royalty income	6	13
	14,309	12,333

1 restated following changes to the Group's organisational structure

2 includes intangible assets, property, plant and equipment and investment property

3 combined sales of the Group and equity accounted investments

4. Operating costs

	2007 £m	2006 £m
Raw materials and other bought in items	5,557	4,169
Change in inventories of finished goods and work-in-progress	13	153
Cost of inventories expensed	5,570	4,322
Staff costs (note 7)	3,924	3,868
Depreciation, amortisation and impairment	610	422
Loss on disposal of property, plant and equipment	4	1
Loss on disposal of businesses (note 9)	8	1
Other operating charges	3,364	3,149
	13,480	11,763

Included within the analysis of operating costs are the following expenses:

Lease and sublease payments:		
Minimum lease payments	112	84
Contingent rents	-	1
	112	85
Research and development expense including amounts funded under contract	1,460	1,248

Fees payable to the Company's auditor and its associates included in operating costs

	2007			2006		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	1,111	-	1,111	1,023	-	1,023
Fees payable to the Company's auditor and its associates for other services						
The audit of the Company's subsidiaries pursuant to legislation*	2,203	3,407	5,610	2,000	2,430	4,430
Other services pursuant to legislation:						
Interim Review	520	-	520	500	-	500
Other including shareholder circular related work	104	-	104	563	22	585
Further assurance services						
Advice on accounting matters	28	-	28	52	-	52
Internal controls	16	-	16	125	-	125
Due diligence	880	1,036	1,916	116	354	470
Tax services						
Compliance	308	793	1,101	301	773	1,074
Advisory	909	488	1,397	687	349	1,036
Other services	313	-	313	46	62	108
Total fees payable to the Company's auditor and its associates	6,392	5,724	12,116	5,413	3,990	9,403

* Total fees payable to the Company's auditor and its associates for audit services **6,721** 5,453

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world. The majority of services provided outside the UK were provided in the US.

Significant one-off costs included in operating costs

	2007 £m	2006 £m
Rationalisation programmes	25	51

	2007 £m	Restated ¹ 2006 £m
Electronics, Intelligence & Support	5	14
Land & Armaments	2	17
Programmes & Support	4	3
International Businesses	9	15
HQ & Other Businesses	5	2
	25	51

1 restated following changes to the Group's organisational structure

Notes to the Group accounts (continued)

5. Other income

	2007 £m	2006 £m
Rental income from operating leases	46	43
Profit on disposal of investment property	47	84
Profit on disposal of property, plant and equipment	1	61
Profit on disposal of businesses (note 9)	48	14
Management recharges to equity accounted investments	15	13
Pension curtailment gains	-	99
Other	52	57
	209	371

6. Finance costs

	2007 £m	2006 £m
Interest income	169	143
Net present value adjustments	21	39
Expected return on pension scheme assets (note 22)	845	739
Net gain on remeasurement of financial instruments	135	259
Net gain on remeasurement of embedded derivatives	-	3
Gain on sale of available-for-sale investments	6	-
Foreign exchange gains	81	147
Financial income	1,257	1,330
Interest expense:		
On bank loans and overdrafts	(4)	(9)
On finance leases	(6)	(11)
On bonds and other financial instruments	(218)	(277)
On preference debt	(13)	(28)
	(241)	(325)
Facility fees	(4)	(4)
Net present value adjustments	(22)	(31)
Interest charge on pension scheme liabilities (note 22)	(753)	(694)
Net loss on remeasurement of investments at fair value through profit or loss	-	(42)
Net loss on remeasurement of financial instruments at fair value through profit or loss	(77)	(172)
Foreign exchange losses	(102)	(257)
Financial expense	(1,199)	(1,525)
Net finance costs	58	(195)

Additional analysis of finance costs

	2007 £m	2006 £m
Net finance costs – Group	58	(195)
Net finance costs – share of equity accounted investments	35	21
	93	(174)
Analysed as:		
Net interest:		
Interest income	169	143
Interest expense	(241)	(325)
Facility fees	(4)	(4)
Net present value adjustments	(1)	8
Gain on sale of available-for-sale investments	6	-
Share of equity accounted investments	33	21
	(38)	(157)
Other finance costs:		
Group:		
Net financing credit on pensions	92	45
Other	37	(62)
Share of equity accounted investments	2	-
	93	(174)

7. Employees and directors

The weekly average and year end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2007 Number '000	Restated ¹ 2006 Number '000	2007 Number '000	Restated ¹ 2006 Number '000
Electronics, Intelligence & Support	31	32	31	32
Land & Armaments	16	11	21	12
Programmes & Support	27	26	27	26
International Businesses	7	8	7	7
HQ & Other Businesses	2	2	2	2
	83	79	88	79

1 restated following changes to the Group's organisational structure

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	2007 £m	2006 £m
Wages and salaries	3,353	3,274
Social security costs	269	271
Share options granted to directors and employees – equity-settled	18	21
Share options granted to directors and employees – cash-settled	40	47
Pension costs – defined contribution plans	62	57
Pension costs – defined benefit plans	178	196
US healthcare plans	4	2
	3,924	3,868

The Group considers key management personnel as defined under IAS 24 Related Party Disclosures to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 64 to 83. Total emoluments for directors and other key management personnel are £19,463,000 (2006 £23,095,000).

8. Tax

Taxation expense

	2007 £m	2006 £m
Current taxation expense		
UK corporation tax		
Current tax	(140)	(91)
Double tax relief	29	35
Adjustment in respect of prior years	(21)	(93)
	(132)	(149)
Overseas tax charges		
Current year	(160)	(91)
Adjustment in respect of prior years	-	15
	(160)	(76)
	(292)	(225)
Deferred taxation expense		
UK		
Origination and reversal of temporary differences	(103)	25
Adjustment in respect of prior years	39	27
Tax rate adjustment ¹	(5)	-
Overseas		
Origination and reversal of temporary differences	22	(49)
Adjustment in respect of prior years	4	5
Attributable to recoverable deferred tax assets	-	4
	(43)	12
Taxation expense	(335)	(213)

1 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.

Notes to the Group accounts (continued)

8. Tax (continued)

The following table shows a reconciliation from the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2007 £m	2006 £m
Profit before tax	1,235	859
UK corporation tax rate	30.0%	30.0%
Expected income tax expense	(371)	(258)
Effect of tax rates in foreign jurisdictions	(13)	(20)
Expenses not tax effected	(38)	(50)
Income not subject to tax	70	69
Research and development tax credits	39	34
Goodwill	(44)	(9)
Chargeable gains	(28)	–
Utilisation of previously unrecognised tax losses	23	–
Recoverable deferred tax asset previously unrecognised	–	4
Current year losses not tax effected	(11)	(9)
Adjustments in respect of prior years	22	(46)
Adjustments in respect of equity accounted investments	36	34
Other	(20)	38
Taxation expense	(335)	(213)

Current tax taken in equity

	2007 £m	2006 £m
Relating to financial instruments	(1)	(1)
Relating to share-based payments	28	–
Relating to pensions	69	22
	96	21

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Property, plant and equipment	1	1	(71)	(68)	(70)	(67)
Intangible assets	–	–	(372)	(143)	(372)	(143)
Provisions	271	261	(2)	(1)	269	260
Goodwill	–	–	(25)	(17)	(25)	(17)
Pension/retirement plans:						
Deficits	522	793	–	(15)	522	778
Additional contributions	106	158	–	–	106	158
Share-based payments	75	82	–	–	75	82
Financial instruments	6	25	–	–	6	25
Other items	16	19	(7)	(47)	9	(28)
Rolled over capital gains	–	–	(18)	(19)	(18)	(19)
Capital losses carried forward	18	19	–	–	18	19
Unremitted overseas earnings	–	–	–	(1)	–	(1)
Trading losses carried forward	7	15	–	–	7	15
Deferred tax assets/(liabilities)	1,022	1,373	(495)	(311)	527	1,062
Set off of tax	(455)	(296)	455	296	–	–
Net deferred tax assets/(liabilities)	567	1,077	(40)	(15)	527	1,062

8. Tax (continued)

Movement in temporary differences during the year

	At 1 January 2007 £m	Exchange movements £m	Acquisitions (note 31) £m	Other movements £m	Recognised in income £m	Recognised in equity £m	At 31 December 2007 £m
Property, plant and equipment	(67)	–	(8)	1	4	–	(70)
Intangible assets	(143)	(5)	(272)	–	47	1	(372)
Provisions	260	(2)	42	(3)	(28)	–	269
Goodwill	(17)	–	18	–	(26)	–	(25)
Pension/retirement plans:							
Deficits	778	(3)	7	–	(50)	(210)	522
Additional contributions	158	–	–	–	(1)	(51)	106
Share-based payments	82	–	–	–	1	(8)	75
Financial instruments	25	–	–	–	(7)	(12)	6
Other items	(28)	2	7	1	25	2	9
Rolled over capital gains	(19)	–	–	–	1	–	(18)
Capital losses carried forward	19	–	–	–	(1)	–	18
Unremitted overseas dividends	(1)	–	–	–	1	–	–
Trading losses carried forward	15	1	–	–	(9)	–	7
	1,062	(7)	(206)	(1)	(43)	(278)	527

	At 1 January 2006 £m	Exchange movements £m	Acquisitions £m	Other movements £m	Recognised in income £m	Recognised in equity £m	At 31 December 2006 £m
Property, plant and equipment	(66)	3	–	1	(5)	–	(67)
Intangible assets	(180)	15	–	(8)	30	–	(143)
Provisions	239	(21)	–	4	38	–	260
Goodwill	11	–	–	–	(28)	–	(17)
Pension/retirement plans:							
Deficits	1,313	(29)	–	6	(130)	(382)	778
Additional contributions	–	–	–	–	18	140	158
Share-based payments	59	(3)	–	(3)	21	8	82
Financial instruments	–	–	–	–	18	7	25
Other items	(57)	(1)	–	7	23	–	(28)
Rolled over capital gains	(24)	–	–	–	5	–	(19)
Capital losses carried forward	24	–	–	–	(5)	–	19
Unremitted overseas dividends	(27)	–	–	–	26	–	(1)
Trading losses carried forward	16	(1)	–	(1)	1	–	15
	1,308	(37)	–	6	12	(227)	1,062

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2007 £m	2006 £m
Deductible temporary differences	22	28
Capital losses carried forward	59	60
Trading and other losses carried forward	140	130
	221	218

These assets have not been recognised as the precise incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time.

The aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures for which deferred tax liabilities have not been recognised is £847m (2006 £500m).

Notes to the Group accounts (continued)

9. Disposals

Continuing operations

On 17 January 2007, the Group completed the sale of its 50% shareholding interest in HR Enterprise Limited and its subsidiary, Xchanging HR Services Limited, (together 'XHRS') to HR Holdco Limited (a company within the Xchanging group) for a cash consideration of £10m.

On 6 March 2007, the Group completed the sale of its 50% shareholding interest in Xchanging Procurement Services (Holdco) Limited (XPS), to XUK Holdco (No.2) Limited (a company within the Xchanging group) for a cash consideration of £47m.

On 20 August 2007, the Group completed the sale of its Inertial Products business to investment affiliates of J. F. Lehman & Company, the US private equity firm, for a cash consideration of \$140m (£70m), subject to potential adjustment according to the level of working capital and net debt or net cash in the business at closing.

On 13 December 2007, the Group completed the sale of its Customer Training Centre (CTC) at Woodford, Manchester, UK, to Flight Academy UK Limited for a cash consideration of £6m.

Profit on disposal of businesses of £48m (note 5) comprises the disposals of XHRS (£nil), XPS (£44m) and CTC (£4m).

Loss on disposal of businesses of £8m (note 4) comprises the disposals of Inertial Products (£6m) and the TEMPEST products business (£2m).

Discontinued operations

On 30 March 2007, the sale of the Group's remaining 25% interest in SELEX Sensor and Airbourne Systems SpA (SELEX) was completed following the exercise by Finmeccanica SpA of its call option granted as part of the original disposal transaction in 2005. Net proceeds of £24m comprise the consideration of £277m, less £253m which was assigned to the BAE Systems 2000 Pension Plan in 2006.

A profit of £22m was recognised during the year upon settlement of warranties and similar obligations.

The results from discontinued operations, which have been included in the consolidated income statement, are shown below. The results for the year ended 31 December 2006 include the results of Airbus SAS for the period to disposal on 13 October 2006.

	2007 £m	2006 £m
Revenue	-	-
Expenses	-	-
EBITA ¹	-	-
<i>Share of results of equity accounted investments excluding finance costs and taxation expense</i>	-	144
<i>Finance costs of equity accounted investments</i>	-	(25)
<i>Taxation expense of equity accounted investments</i>	-	(49)
Share of results of equity accounted investments	-	70
Financial income, net	-	2
Profit before taxation	-	72
Taxation expense	-	(4)
Profit for the year	-	68
Profit on disposal of discontinued operations	22	925
Profit for the year from discontinued operations	22	993

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

Proceeds from the sale of subsidiary undertakings in the consolidated cash flow statement of £96m in 2007 comprise the disposals of Inertial Products (£70m), SELEX (£24m), CTC (£6m) and TEMPEST (£1m), less transaction costs (£5m).

10. Earnings per share

	2007				2006			
	£m	Basic pence per share	£m	Diluted pence per share	£m	Basic pence per share	£m	Diluted pence per share
Profit for the year attributable to equity shareholders	901		901		1,636		1,636	
Interest on the debt instrument of the convertible preference shares	-		13		-		28	
Profit for the year after adjusting for interest on the debt instrument of the convertible preference shares	901	26.6	914	26.4	1,636	50.7	1,664	49.2
Represented by:								
Continuing operations	879	26.0	892	25.8	643	19.9	671	19.8
Discontinued operations	22	0.6	22	0.6	993	30.8	993	29.4
Add back/(deduct):								
Net financing credit on pensions, post tax	(68)		(68)		(33)		(33)	
Uplift on acquired inventories, post tax	9		9		-		-	
Market value movements on derivatives, post tax	(29)		(29)		55		55	
Amortisation and impairment of intangible assets, post tax	110		110		79		79	
Impairment of goodwill	148		148		32		32	
Underlying earnings	1,071	31.6	1,084	31.3	1,769	54.9	1,797	53.1
Represented by:								
Continuing operations	1,049	31.0	1,062	30.7	767	23.8	795	23.5
Discontinued operations	22	0.6	22	0.6	1,002	31.1	1,002	29.6
	1,071	31.6	1,084	31.3	1,769	54.9	1,797	53.1
Underlying earnings excluding profit on disposal of Airbus SAS (2006 £925m)					844	26.2	872	25.8
Represented by:								
Continuing operations					767	23.8	795	23.5
Discontinued operations					77	2.4	77	2.3
					844	26.2	872	25.8
		Millions		Millions		Millions		Millions
Weighted average number of shares used in calculating basic earnings per share		3,386		3,386		3,225		3,225
Add:								
Incremental shares in respect of employee share schemes				24				32
Incremental shares in respect of convertible preference shares				56				125
Weighted average number of shares used in calculating diluted earnings per share				3,466				3,382

Underlying earnings per share is presented in addition to that required by IAS 33 Earnings per share as the directors consider that this gives a more appropriate indication of underlying performance.

In accordance with IAS 33, the diluted earnings per share are without reference to adjustments in respect of outstanding share options and convertible preference shares where the impact would be anti-dilutive.

Notes to the Group accounts (continued)

11. Intangible assets

	Goodwill £m	Other ¹ £m	Total £m
Cost or valuation			
At 1 January 2006	9,722	678	10,400
Additions:			
Acquired separately	–	25	25
Internally generated	–	2	2
Acquisition of subsidiaries	4	–	4
Adjustments to provisional fair values	(8)	3	(5)
Disposals	(6)	(2)	(8)
Reclassified to equity accounted investments	(28)	–	(28)
Exchange adjustments	(480)	(49)	(529)
At 31 December 2006	9,204	657	9,861
Additions:			
Acquired separately	–	31	31
Acquisition of subsidiaries (note 31)	1,563	753	2,316
Disposals	(31)	(4)	(35)
Asset reclassifications	(2)	2	–
Reclassified as non-current assets and disposal groups held for sale (note 19)	(42)	–	(42)
Exchange adjustments	(31)	12	(19)
At 31 December 2007	10,661	1,451	12,112
Amortisation and impairment			
At 1 January 2006	2,090	93	2,183
Disposals	(5)	(2)	(7)
Amortisation charge ²	–	105	105
Impairment charge	32	2	34
Exchange adjustments	(46)	(3)	(49)
At 31 December 2006	2,071	195	2,266
Disposals	(1)	(4)	(5)
Amortisation charge ²	–	149	149
Impairment charge	148	–	148
Exchange adjustments	(5)	–	(5)
At 31 December 2007	2,213	340	2,553
Net book value			
At 31 December 2007	8,448	1,111	9,559
At 31 December 2006	7,133	462	7,595
At 1 January 2006	7,632	585	8,217

1 other intangibles includes internally funded development costs and intangible assets recognised on acquisition of subsidiary companies, of which the most significant are in respect of the acquired order book and of ongoing programme relationships

2 amortisation is included in operating costs in the income statement

The Group has no indefinite life intangible assets other than goodwill. The Group has allocated its goodwill across approximately 20 cash-generating units. Other than the goodwill allocated to the US operations within the Land & Armaments business group acquired as part of the acquisition of United Defense Industries, Inc. in 2005 (£1,984m) and Armor Holdings, Inc. in 2007 (£1,554m), none of the cash-generating units has allocated goodwill exceeding 10% of the Group's total goodwill balance.

The Group's approach to goodwill impairment testing is set out in the accounting policies on page 94. All significant goodwill balances have been considered with regard to value in use calculations.

The key assumption underpinning the Integrated Business Plan projections for the US operations within the Land & Armaments business group is that US government defence spending will remain broadly stable in the foreseeable future. The directors have not identified any reasonable possible changes in key assumptions for this business that would cause the carrying value of recognised goodwill to exceed its recoverable amount.

Beyond the assumptions that US and UK government defence spending remains stable there are no individually significant assumptions made in relation to the other cash-generating units where changes to key assumptions would cause the carrying value of recognised goodwill to exceed its recoverable amount.

The result of the review of the carrying value of goodwill across the Group is an impairment charge of £148m (2006 £32m). The majority of the impairment charge relates to the Insyte business within Programmes & Support reflecting lower exports and Homeland Security activity.

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2006	1,233	2,120	548	3,901
Additions	214	184	113	511
Transfers from inventories	-	1	-	1
Transfers to inventories	-	(3)	-	(3)
Transfers from investment property	2	-	-	2
Reclassification between categories	9	(9)	-	-
Disposals	(80)	(147)	(1)	(228)
Exchange adjustments	(65)	(68)	(54)	(187)
At 31 December 2006	1,313	2,078	606	3,997
Additions	96	190	24	310
Acquisition of subsidiaries (note 31)	32	54	6	92
Transfers from inventories	-	5	-	5
Transfers to inventories	-	(6)	(1)	(7)
Reclassified as non-current assets and disposal groups held for sale (note 19)	(11)	(16)	-	(27)
Disposals	(24)	(172)	(25)	(221)
Disposal of subsidiaries	(10)	(29)	-	(39)
Exchange adjustments	(10)	(9)	(8)	(27)
At 31 December 2007	1,386	2,095	602	4,083
Depreciation and impairment				
At 1 January 2006	408	1,507	282	2,197
Depreciation charge for the year	49	149	28	226
Impairment loss for the year	-	-	53	53
Transfers to inventories	-	(1)	-	(1)
Transfers from investment property	1	-	-	1
Reclassification between categories	2	(2)	-	-
Disposals	(18)	(132)	(1)	(151)
Exchange adjustments	(9)	(41)	(24)	(74)
At 31 December 2006	433	1,480	338	2,251
Depreciation charge for the year	67	155	32	254
Impairment loss for the year ¹	19	2	34	55
Transfers to inventories	-	(4)	-	(4)
Reclassified as non-current assets and disposal groups held for sale (note 19)	(5)	(13)	-	(18)
Disposals	(15)	(170)	(10)	(195)
Disposal of subsidiaries	(4)	(21)	-	(25)
Exchange adjustments	(1)	(3)	(5)	(9)
At 31 December 2007	494	1,426	389	2,309
Net book value				
At 31 December 2007	892	669	213	1,774
At 31 December 2006	880	598	268	1,746
At 1 January 2006	825	613	266	1,704

1. During the year, the directors revised the valuation methodology used to determine the value of regional aircraft with a £34m impairment charge arising and a £45m increase to provisions in respect of residual value guarantees

The amounts above include:

Net book value of assets held as capitalised finance leases (including investment property (note 13))

At 31 December 2007	6	11	16	33
At 31 December 2006	1	17	15	33

Assets in the course of construction (including investment property (note 13))

At 31 December 2007	88	68	-	156
At 31 December 2006	148	68	-	216

Notes to the Group accounts (continued)

12. Property, plant and equipment (continued)

Net book value of:

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Freehold property	809	–	–	809
Long leasehold property	55	–	–	55
Short leasehold property	28	–	–	28
Plant and machinery	–	594	–	594
Fixtures, fittings and equipment	–	75	–	75
Aircraft	–	–	213	213
	892	669	213	1,774

The aircraft fleet that is held under capitalised finance lease arrangements is leased to airline companies under operating leases. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	2007 £m	2006 £m
Receipts due:		
Not later than one year	93	72
Later than one year and not later than five years	234	185
Later than five years	63	63
	390	320

Under the terms of the lease agreements, no contingent rents are payable. Within the above lease income is £15m (2006 £25m) relating to assets held by the Group under capitalised finance leases.

13. Investment property

	£m
Cost	
At 1 January 2006	272
Transfers to property, plant and equipment	(2)
Disposals	(103)
At 31 December 2006	167
Disposals	(9)
At 31 December 2007	158
Depreciation and impairment	
At 1 January 2006	54
Transfers to property, plant and equipment	(1)
Depreciation charge for the year	4
Disposals	(13)
At 31 December 2006	44
Depreciation charge for the year	4
Disposals	(3)
At 31 December 2007	45
Net book value of investment property	
At 31 December 2007	113
At 31 December 2006	123
At 1 January 2006	218
Fair value of investment property	
At 31 December 2007	160
At 31 December 2006	218

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification and with recent experience in valuing properties in the location and the type of property being valued.

	2007 £m	2006 £m
Rental income from investment property	20	19

14. Equity accounted investments

Carrying value of equity accounted investments

	Share of net assets £m	Purchased goodwill £m	Carrying value £m
At 1 January 2006	317	1,404	1,721
Share of results after tax – continuing operations	113	–	113
Share of results after tax – discontinued operations (note 9)	70	–	70
Acquired through acquisition	(62)	66	4
Reclassified from intangible assets	–	28	28
Disposal	(239)	(1,063)	(1,302)
Dividends	(145)	–	(145)
Market value adjustments in respect of derivative financial instruments, net of tax	144	–	144
Actuarial gains on defined benefit pension schemes, net of tax	59	–	59
Revaluation of net assets acquired by equity accounted investments ¹	5	–	5
Foreign exchange adjustment	(24)	(2)	(26)
At 31 December 2006	238	433	671
Share of results after tax – continuing operations	139	–	139
Acquired through acquisition	1	–	1
Adjustment to provisional fair values	3	(3)	–
Disposal	(10)	–	(10)
Dividends	(78)	–	(78)
Market value adjustments in respect of derivative financial instruments, net of tax	(2)	–	(2)
Actuarial gains on defined benefit pension schemes, net of tax	17	–	17
Foreign exchange adjustment	13	30	43
At 31 December 2007	321	460	781

1 The revaluation gain in 2006 arose as a result of MBDA SAS acquiring control of LFK GmbH, which was previously accounted for as a trade investment. The £5m gain reflects a fair value uplift in respect of the carrying value of the original investment. The gain is reflected as a credit to equity (note 27).

Included within purchased goodwill is £110m (2006 £113m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

The market value of the Group's shareholding in Saab AB at 31 December 2007 was £225m (2006 £350m).

Share of results of equity accounted investments by continuing business group

	2007 £m	Restated ² 2006 £m
Share of results excluding finance costs and taxation expense:		
Electronics, Intelligence & Support	1	1
Programmes & Support	27	25
International Businesses	114	94
HQ & Other Businesses	–	7
	142	127
Financial income	35	21
Taxation expense	(38)	(35)
	139	113

2 restated following changes to the Group's organisational structure

Share of the assets and liabilities of equity accounted investments

	2007 £m	2006 £m
Assets:		
Non-current assets	892	856
Current assets	3,032	2,633
	3,924	3,489
Liabilities:		
Non-current liabilities	(618)	(582)
Current liabilities	(2,525)	(2,236)
	(3,143)	(2,818)
Carrying value	781	671

Notes to the Group accounts (continued)

14. Equity accounted investments (continued)

Principal equity accounted investments

Joint ventures	Principal activities	Principally operates in	Country of incorporation
Air Astana JSC (49%) (Held by BAE Systems (Kazakhstan) Limited)	Commercial aerospace activities	Kazakhstan	Kazakhstan
Eurofighter Jagdflugzeug GmbH (33%) (Held by BAE Systems plc)	Management and control of Typhoon programme	Germany	Germany
Flagship Training Limited (50%) (Held via BAE Systems Electronics Limited)	Supply of naval training and support services	UK	England and Wales
Fleet Support Limited (50%) (Held via BAE Systems Surface Fleet Solutions Limited)	Engineering and facilities management support to the Royal Navy	UK	England and Wales
Gripen International KB (50%) (Held via BAE Systems (Operations) Limited)	Marketing and selling of Gripen fighter aircraft	Sweden	Sweden
MBDA SAS (37.5%) (Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)	Development and manufacture of guided weapons	Europe	France
Panavia Aircraft GmbH (42.5%) (Held via BAE Systems plc)	Management and control of Tornado programme	Germany	Germany
Saab AB (20.5%) (Held via BAE Systems (Sweden) AB)	Defence and commercial aerospace activities	Sweden	Sweden

15. Other investments

	2007 £m	2006 £m
Non-current		
Loans and receivables		
Term deposits	-	4
Available-for-sale financial assets		
Equity securities	6	7
	6	11
Current		
Loans and receivables		
Term deposits	164	503
	164	503

Reconciliation of movements

	2007 £m	2006 £m
Non-current		
At 1 January	11	9
Additions	1	5
Disposals	(11)	(1)
Creation of impairment provision	-	(2)
Fair value movements	5	-
At 31 December	6	11
Current		
At 1 January	503	634
Additions	19	499
Disposals	(358)	(588)
Fair value movements recognised in finance costs	-	(42)
At 31 December	164	503

Exchange Property

The Group's shareholding in Vodafone Group Plc (Exchange Property) was disposed of during 2006.

The Group had designated the Exchange Property as at fair value through profit or loss. Accordingly, movements in the fair value of the Exchange Property in 2006 to disposal of £42m were recognised in finance costs in the income statement (note 6).

16. Trade and other receivables

	2007 £m	2006 ¹ £m
Non-current		
Other receivables	255	496
Pension prepayment (note 22)	57	66
Prepayments and accrued income	10	7
	322	569
Current		
Long-term contract balances	4,389	4,440
Less: attributable progress payments	(4,013)	(4,027)
Amounts due from contract customers ¹	208	151
Amounts due from customers for contract work	584	564
Trade receivables ¹	1,608	1,060
Amounts owed by equity accounted investments	239	218
Other receivables	281	225
Pension prepayment (note 22)	2	5
Prepayments and accrued income	219	181
	2,933	2,253

1 Following the adoption of IFRS 7, the Group has reviewed the categorisation of its trade and other receivables. As a result of this review, the comparative amount for amounts due from contract customers has been restated by £429m from £580m to £151m and the comparative amount for trade receivables has been restated by £429m from £631m to £1,060m.

Included within amounts due from customers for contract work:

	2007 £m	2006 £m
Retentions outstanding against long-term contracts	1	1

The ageing of trade receivables is detailed below:

	2007			2006		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due – 180 days	1,342	(17)	1,325	1,060	(7)	1,053
Past 180 days	319	(36)	283	31	(24)	7
	1,661	(53)	1,608	1,091	(31)	1,060

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows:

	2007 £m	2006 £m
At 1 January	31	46
Created	42	20
Released	(22)	(24)
Exchange adjustments	-	(2)
Acquisitions/(disposals)	3	(1)
Utilised	(1)	(8)
At 31 December	53	31

The other classes within trade and other receivables do not contain impaired assets.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk. All credit and recovery risk associated with trade receivables has been provided for in the balance sheet.

Notes to the Group accounts (continued)

17. Other financial assets and liabilities

	2007 Assets £m	2007 Liabilities £m	2006 Assets £m	2006 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	34	(20)	30	(43)
Other foreign exchange/interest rate contracts	14	(6)	21	(2)
	48	(26)	51	(45)
Current				
Cash flow hedges – foreign exchange contracts	63	(44)	36	(36)
Other foreign exchange/interest rate contracts	38	(27)	14	(14)
	101	(71)	50	(50)
Debt-related derivative financial instruments				
Other foreign exchange/interest rate derivatives	17	(190)	6	(243)

The debt-related derivative financial instruments are presented as a component of loans and overdrafts (note 20).

The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £4m (2006 gain of £5m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £nil (2006 £nil).

The notional principal amounts of the outstanding contracts are detailed in note 32.

18. Inventories

	2007 £m	2006 £m
Short-term work-in-progress	304	205
Raw materials and consumables	285	100
Finished goods and goods for resale	112	90
	701	395

The Group recognised £53m (2006 £20m) as a write down of inventories to net realisable value in 2007.

19. Disposal groups

On 19 December 2007, the Group agreed the sale of its Surveillance and Attack business to Sensor and Antenna Systems, Lansdale, Inc., a subsidiary of Cobham Defence Electronic Systems Corporation, for a cash consideration of \$240m (£121m). Completion of the sale is conditional upon regulatory approvals being given and is expected to take place in the first quarter of 2008. Accordingly, the business is presented as held for sale on the balance sheet as at 31 December 2007.

The Group's Mobile International business was acquired with Armor Holdings, Inc. on 31 July 2007 (note 31) with a view to immediate resale. Accordingly, it is classified as held for sale in the acquisition balance sheet and as at 31 December 2007.

The assets and liabilities of Surveillance and Attack, and Mobile International relate to the Electronics, Intelligence & Support and Land & Armaments business groups, respectively.

	Surveillance and Attack £m	Mobile International £m	2007 £m	2006 £m
Non-current assets				
Intangible assets	42	1	43	–
Property, plant and equipment	9	9	18	–
	51	10	61	–
Current assets				
Inventories	7	17	24	–
Trade and other receivables	2	7	9	–
	9	24	33	–
Assets of disposal groups	60	34	94	–
Current liabilities				
Trade and other payables	(4)	(26)	(30)	–
	(4)	(26)	(30)	–
Liabilities of disposal groups	(4)	(26)	(30)	–

20. Loans and overdrafts

	2007 £m	2006 £m
Non-current		
Euro-Sterling £150m 11¾% bond, repayable 2008	-	150
European Investment Bank loan, final instalment 2009	4	11
Alvis loan notes, redeemable 2009	1	1
Debt instrument of the convertible preference shares, redeemable 2010	-	242
US\$500m 4.75% bond, repayable 2010	254	249
US\$1bn 6.4% bond, repayable 2011	517	515
Class B and Class G certificates, final instalments 2011/2013	498	599
Euro-Sterling £100m 10¾% bond, repayable 2014	99	99
US\$750m 5.2% bond, repayable 2015	376	382
US\$500m 7.5% bond, repayable 2027	249	253
Bank loans	6	28
Obligations under finance leases	20	31
Debt-related derivative financial instruments	173	216
	2,197	2,776
Current		
Bank loans and overdrafts	41	33
US\$200m 7% bond, repayable 2007	-	102
Euro-Sterling £150m 11¾% bond, repayable 2008	150	-
European Investment Bank loan, final instalment 2009	7	7
Class B and Class G certificates, final instalment 2011/2013	87	82
Obligations under finance leases	14	23
Debt-related derivative financial instruments	-	21
Eurofighter GmbH loan	-	66
	299	334

The maturity of the Group's borrowings is as follows:

	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
At 31 December 2007				
Carrying amount	299	1,157	1,040	2,496
Contractual cash flows ¹	484	1,649	1,370	3,503
At 31 December 2006				
Carrying amount	334	1,578	1,198	3,110
Contractual cash flows ¹	653	1,947	1,554	4,154

¹ including interest payments

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts are settled within the normal operating cycle of the business. Non-current amounts are expected to be settled between one and five years.

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

For more information on the debt instrument of the convertible preference shares refer to note 1.

The US\$500m 4.75% bond, repayable 2010 was converted on issue to a floating rate bond by utilising an interest rate swap giving an effective rate during 2007 of 5.85%.

The US\$1bn 6.4% bond, repayable 2011 has been partially converted to a floating rate bond by utilising a series of interest rate swaps with different tenors; US\$500m has been swapped until maturity of the bond in 2011 and US\$250m was swapped until December 2007. This has been overlaid by US\$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2007 was 6.49% with an interest rate split on the bond at 31 December 2007 being US\$800m fixed and US\$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013 respectively with fixed US\$ coupon rates of 7.156% and 6.664%, giving a weighted average interest rate of 6.879%. At 31 December 2007, the gross outstanding principal due is US\$1,138m. Of this balance, US\$348m has 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% on this element.

The US\$500m 7.5% bond, repayable 2027 was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

Notes to the Group accounts (continued)

20. Loans and overdrafts (continued)

The debt-related derivative financial instruments represent the market value of certain interest rate and cross-currency derivatives which are specifically hedging loans disclosed within the above note. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

The US\$200m 7% bond was repaid in July 2007.

The Eurofighter GmbH loan represented surplus cash lent by Eurofighter GmbH to its shareholders. The loan incurred interest at LIBOR minus 10bp and was repaid in January 2007.

Finance lease obligations

The Group has a number of non-cancellable finance lease arrangements predominantly in respect of aircraft. The maturity of these lease liabilities from the balance sheet date is shown below.

	2007 £m	2006 £m
Finance lease liabilities – minimum lease payments due:		
Not later than one year	15	24
Later than one year and not later than five years	22	37
	37	61
Future finance charges on finance leases	(3)	(7)
Present value of finance lease liabilities	34	54
Present value of finance lease liabilities – payments due:		
Not later than one year	14	23
Later than one year and not later than five years	20	31
	34	54

Under the terms of the lease agreements, no contingent rents are payable.

The interest rate inherent in these finance leases is fixed at the contract date for all of the lease term. The average interest rate on finance lease payables at 31 December 2007 was 7% (2006 7%).

21. Trade and other payables

	2007 £m	2006 £m
Non-current		
Amounts due to long-term contract customers	56	113
Cash received on customers' account ¹ for long-term contracts	2	43
Amounts owed to equity accounted investments	7	10
Other payables	306	287
Accruals and deferred income	42	12
	413	465
Current		
Amounts due to long-term contract customers	4,710	3,836
Amounts due to other customers	162	153
Cash received on customers' account ¹ :		
Long-term contracts	27	16
Others	1	3
Trade payables	913	638
Amounts owed to equity accounted investments	847	616
Other taxes and social security costs	58	34
Other payables	297	343
Accruals and deferred income	1,230	1,078
	8,245	6,717
Included above:	2007 £m	2006 £m
Amounts due to long-term contract customers	4,795	4,008

¹ Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payments guarantees unrelated to company performance.

22. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19 deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries and updated to take account of the requirements of IAS 19 in order to assess the deficit of the plans at 31 December each year. Plan assets are shown at the bid value at 31 December each year.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2007. The method of accounting for these is similar to that used for defined benefit pension plans.

The financial assumptions used to calculate liabilities for the principal plans were:

	UK			US		
	2007 %	2006 %	2005 %	2007 %	2006 %	2005 %
Inflation rate	3.3	3.0	2.8	3.0	3.0	3.0
Rate of increase in salaries	4.3	4.0	3.8	5.8	5.8	5.8
Rate of increase for pensions in payment	2.3 – 3.3	2.9 – 3.0	2.6 – 2.8	–	–	–
Rate of increase for deferred pensions	3.3	3.0	2.8	n/a	n/a	n/a
Discount rate	5.8	5.2	4.8	6.5	5.9	5.8
Long-term healthcare cost increases	n/a	n/a	n/a	5.4	5.5	5.6

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid value of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of plan liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, as at 31 December are shown in the tables below.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2007, used PA 00 (2006 PA 92) medium cohort 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 plan members. For its US pension arrangements the mortality tables used for pensioners and non-pensioners are RP 2000 projected to 2010. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 18 to 22 years for current male pensioners at age 65 and 21 to 25 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 10% in 2007 reducing to 5% by 2015 for pre-retirement and 10% in 2007 reducing to 5% for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Additional disclosure – summary of movements of the retirement benefit obligations

	UK £m	US and other £m	Total £m
Deficit in defined benefit pension plans at 1 January 2007	(2,866)	(301)	(3,167)
Transfers arising on acquisitions	–	(22)	(22)
Actual return on assets (below)/above expected return	(171)	15	(156)
Decrease in liabilities due to changes in assumptions	817	135	952
One-off contributions	76	–	76
Recurring contributions over service cost	166	48	214
Other movements	70	34	104
Deficit in defined benefit pension plans at 31 December 2007	(1,908)	(91)	(1,999)
US healthcare plans	–	(21)	(21)
Total IAS 19 deficit	(1,908)	(112)	(2,020)
Allocated to equity accounted investments and other participating employers	450	–	450
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers	(1,458)	(112)	(1,570)

Notes to the Group accounts (continued)

22. Retirement benefit obligations (continued)

Amounts recognised on the balance sheet

	2007				2006			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	(1)	(97)	(13)	(111)	–	(80)	(15)	(95)
Present value of funded obligations	(15,099)	(1,912)	(103)	(17,114)	(15,445)	(1,931)	(111)	(17,487)
Fair value of plan assets	13,192	1,918	95	15,205	12,579	1,710	91	14,380
Total IAS 19 deficit, net	(1,908)	(91)	(21)	(2,020)	(2,866)	(301)	(35)	(3,202)
Allocated to equity accounted investments and other participating employers ¹	450	–	–	450	774	–	–	774
Group's share of IAS 19 deficit, net	(1,458)	(91)	(21)	(1,570)	(2,092)	(301)	(35)	(2,428)
Group's share of IAS 19 deficit of equity accounted investments	(49)	–	–	(49)	(83)	–	–	(83)
Represented by:								
Pension prepayments (within trade and other receivables)	14	32	13	59	35	25	11	71
Retirement benefit obligations	(1,472)	(123)	(34)	(1,629)	(2,127)	(326)	(46)	(2,499)
Group's share of IAS 19 deficit, net	(1,458)	(91)	(21)	(1,570)	(2,092)	(301)	(35)	(2,428)

1 Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during the year ended 31 December 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments.

Amounts for the current and previous four years are as follows:

Defined benefit pension plans	2007 £m	2006 £m	2005 £m	2004 £m	2003 £m
Defined benefit obligations	(17,109)	(17,456)	(17,767)	(14,482)	(12,386)
Plan assets ²	15,110	14,289	12,461	10,143	9,305
Total deficit before tax and allocation to equity accounted investments and other participating employers	(1,999)	(3,167)	(5,306)	(4,339)	(3,081)
Actuarial gain/(loss) on plan liabilities	952	473	(2,100)	(1,221)	(788)
Actuarial (loss)/gain on plan assets	(156)	521	1,138	265	827

2 at bid value

22. Retirement benefit obligations (continued)

Assets of defined benefit pension plans

	2007							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,296	63	8.0	1,384	72	9.25	9,680	64
Bonds	3,331	25	4.9	305	16	6.0	3,636	24
Property	1,142	9	6.0	115	6	7.0	1,257	8
Other	423	3	5.5	114	6	5.0	537	4
Total	13,192	100	7.0	1,918	100	8.25	15,110	100

	2006							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,232	65	8.0	1,324	77	8.75	9,556	67
Bonds	2,735	22	4.8	260	15	5.5	2,995	21
Property	1,255	10	6.25	–	–	n/a	1,255	9
Other	357	3	5.0	126	8	7.0	483	3
Total	12,579	100	7.0	1,710	100	8.5	14,289	100

When setting the overall expected rate of return on plan assets, historical markets are studied and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows:

	UK defined pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2006	10,833	1,628	92	12,553
Assets acquired on acquisitions	–	4	–	4
<i>Expected return on assets</i>	779	132	6	917
<i>Actuarial gain</i>	421	100	3	524
Actual return on assets	1,200	232	9	1,441
<i>Contributions by employer</i>	960	137	10	1,107
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	86	–	–	86
Total contributions by employer	1,046	137	10	1,193
Members' contributions (including DWP ³ rebates)	42	11	–	53
Currency loss	–	(214)	(12)	(226)
Benefits paid	(542)	(88)	(8)	(638)
Value of plan assets at 31 December 2006	12,579	1,710	91	14,380
Assets acquired on acquisitions ⁴	–	55	–	55
<i>Expected return on assets</i>	879	144	7	1,030
<i>Actuarial (loss)/gain</i>	(171)	15	(3)	(159)
Actual return on assets	708	159	4	871
<i>Contributions by employer</i>	384	103	8	495
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	107	–	–	107
Total contributions by employer	491	103	8	602
Members' contributions (including DWP ³ rebates)	29	10	–	39
Currency loss	–	(25)	(1)	(26)
Benefits paid	(615)	(94)	(7)	(716)
Value of plan assets at 31 December 2007	13,192	1,918	95	15,205

³ Department for Work and Pensions

⁴ on 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31)

Notes to the Group accounts (continued)

22. Retirement benefit obligations (continued)

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2006	(15,492)	(2,275)	(144)	(17,911)
Net liabilities transferred on acquisitions/disposals ⁵	–	62	–	62
<i>Current service cost</i>	(173)	(60)	(2)	(235)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(86)	–	–	(86)
Total current service cost	(259)	(60)	(2)	(321)
Members' contributions (including DWP ³ rebates)	(42)	(11)	–	(53)
Past service cost	(7)	(2)	–	(9)
Actuarial gain/(loss) on liabilities	499	(26)	2	475
Curtailement gains	52	61	–	113
Interest expense	(738)	(118)	(8)	(864)
Currency gain	–	270	18	288
Benefits paid	542	88	8	638
Defined benefit obligations at 31 December 2006	(15,445)	(2,011)	(126)	(17,582)
Net liabilities assumed on acquisitions ⁴	–	(77)	–	(77)
<i>Current service cost</i>	(142)	(55)	(2)	(199)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(107)	–	–	(107)
Total current service cost	(249)	(55)	(2)	(306)
Members' contributions (including DWP ³ rebates)	(29)	(10)	–	(39)
Past service cost	(14)	–	(2)	(16)
Actuarial gain on liabilities	817	135	12	964
Interest expense	(795)	(115)	(7)	(917)
Currency gain	–	30	2	32
Benefits paid	615	94	7	716
Defined benefit obligations at 31 December 2007	(15,100)	(2,009)	(116)	(17,225)

3 Department for Work and Pensions

4 on 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31)

5 includes liabilities of £67m transferred on the disposal of Atlas Elektronik GmbH

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2007 were £403m (2006 £1,020m). In 2008, the Group expects to make regular contributions at a similar level to those made in 2007. The Group also incurred a charge in respect of the cash contributions of £62m (2006 £57m) paid to defined contribution plans for employees. It expects to make a contribution of £63m to these plans in 2008.

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2007				2006			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs:								
Current service cost	(113)	(55)	(2)	(170)	(129)	(60)	(2)	(191)
Past service cost	(10)	–	(2)	(12)	(5)	(2)	–	(7)
	(123)	(55)	(4)	(182)	(134)	(62)	(2)	(198)
Included in other income:								
Curtailements and settlements	–	–	–	–	49	61	–	110
Included in finance costs:								
Expected return on plan assets	694	144	7	845	601	132	6	739
Interest on obligations	(631)	(115)	(7)	(753)	(568)	(118)	(8)	(694)
	63	29	–	92	33	14	(2)	45
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	(6)	–	–	(6)	(7)	–	–	(7)
Group's share of equity accounted investments' finance costs	2	–	–	2	–	–	–	–

22. Retirement benefit obligations (continued)

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
Effect on the aggregate of service cost and interest cost	0.2	0.2
Effect on defined benefit obligations	2	2

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Effect on defined benefit obligations	1.2	1.4

23. Provisions

	Aircraft financing £m	Warranties and after-sales service £m	Reorganisations – ongoing operations £m	Legal costs, environmental and other £m	Total £m
Non-current	–	82	14	175	271
Current	52	65	38	269	424
At 1 January 2007	52	147	52	444	695
Created	105	48	14	238	405
Released	(49)	(23)	(13)	(94)	(179)
Utilised	(20)	(22)	(25)	(114)	(181)
Provisions and fair values arising on acquisitions (note 31)	–	9	–	61	70
On disposals	–	(5)	–	–	(5)
Discounting	–	–	–	7	7
Exchange adjustments	(3)	2	–	(2)	(3)
Other provision movements	–	1	–	(1)	–
At 31 December 2007	85	157	28	539	809
Represented by:					
Non-current	65	93	4	237	399
Current	20	64	24	302	410
	85	157	28	539	809

Aircraft financing

The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. Further information is provided in note 24. Such costs are generally incurred within five years.

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. Such costs are generally incurred within three years post-delivery.

Reorganisations – ongoing operations

The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years.

Legal costs, environmental and other provisions

The Group holds provisions for expected legal, environmental and other costs that it expects to incur over an extended period. These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Included within legal costs, environmental and other is £75m (2006 £82m) in respect of the cash-settled elements of certain of the Group's share option schemes (note 26). The costs in respect of this liability are expected to occur over the next five years.

Notes to the Group accounts (continued)

24. Contingent liabilities and commitments

Aircraft financing contingent liabilities

Included within the aircraft financing provision of £85m (note 23) is an exposure of £70m as discussed below:

	2007 £m	2006 £m
Potential future cash flow payments in respect of aircraft financing obligations	134	191
Anticipated aircraft values	(55)	(159)
Adjustments to net present values	(9)	(5)
Net exposure provided	70	27

The Group has provided residual value guarantees (RVGs) in respect of certain commercial aircraft sold. At 31 December 2007 the Group's exposure to make future payments in respect of these arrangements was £134m (2006 £191m). The Group's net exposure to these guarantees is covered by the provisions held and the residual values of the related aircraft.

The net exposure has increased during the year as a result of the re-assessment of anticipated aircraft values and the settlement of the commitments of six RVGs.

The Group is also exposed to actual and contingent liabilities arising from commercial aircraft financing and RVGs given by Saab AB. Provision is made against the expected net exposures on a net present value basis within the accounts of Saab. The Group's share of such exposure is limited to its percentage shareholding in Saab.

Guarantees and performance bonds

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

Operating lease commitments – where the Group is the lessee

The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2007 £m	2006 £m
Payments due:		
Not later than one year	125	121
Later than one year and not later than five years	460	393
Later than five years	731	731
	1,316	1,245
Total of future minimum sublease income under non-cancellable subleases	249	212

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2007 £m	2006 £m
Property, plant and equipment	121	133
Intangible assets	6	5
	127	138

Treasury contingent liabilities

Treasury contingent liabilities are set out in note 32.

Other contingent liabilities

The Group is subject to an ongoing investigation by the UK Serious Fraud Office (the SFO) in connection with marketing of the Group's products. The Group is co-operating fully with the SFO.

At this stage management cannot determine whether or not it might lead to any proceedings being brought against the Group. Accordingly, the potential for fines or other penalties cannot currently be assessed, although the directors continue to consider that the Group has not acted unlawfully in relation to any of the matters under investigation. As the investigation is ongoing it is not possible to identify the timescale in which these issues might be resolved.

In addition, in June 2007, the US Department of Justice notified the Group that it had commenced a formal investigation relating to the Group's compliance with anti-corruption laws, including its business concerning the Kingdom of Saudi Arabia. Again, given the status of this matter it is not possible to provide any details of any possible future financial effects that might result from the investigation and any subsequent actions or events that might occur as a result of the investigation. Equally it is not possible to provide any timescale in which these issues might be resolved. The directors continue to consider that the Group has not acted unlawfully in relation to its dealings with the Kingdom of Saudi Arabia or in relation to anti-corruption laws.

Should any financial effects arise as a result of these investigations the directors consider it unlikely that there is any likelihood of reimbursement for such costs from any sources other than certain rights to recover reimbursement of the legal costs under the Group's insurance policies.

25. 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 IAS 32 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 (note 27) and within loans and overdrafts (note 20) 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 Group accounts (continued)

26. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 64 to 83.

Executive Share Option Scheme (ExSOS) Equity-settled options

	2007		2006	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	56,202	2.80	71,399	2.78
Granted during the year	6,161	4.59	6,082	4.28
Converted during the year	-	-	8,641	2.15
Exercised during the year	(19,294)	2.34	(13,353)	2.40
Expired during the year	(11,341)	3.07	(16,567)	3.23
Outstanding at the end of the year	31,728	3.33	56,202	2.80
Exercisable at the end of the year	9,922	2.68	16,269	2.86

Cash-settled share appreciation rights

	2007		2006	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	35,805	2.82	69,129	2.88
Converted during the year	-	-	(8,641)	2.15
Exercised during the year	(8,512)	2.48	(4,843)	2.29
Expired during the year	(10,300)	3.32	(19,840)	3.45
Outstanding at the end of the year	16,993	2.67	35,805	2.82
Exercisable at the end of the year	11,452	2.67	11,736	3.01

	2007		2006	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	1.72 - 4.87	1.72 - 4.21	1.72 - 4.87	1.72 - 4.21
Weighted average remaining contracted life (years)	7	6	7	6
Weighted average fair value of options granted (£)	1.46	-	1.30	-
Expense recognised for the year (£m)	8	15	9	18

Performance Share Plan (PSP) Equity-settled options

	2007	2006
	Number of shares '000	Number of shares '000
Outstanding at the beginning of the year	25,608	18,917
Granted during the year	4,107	4,055
Converted during the year	-	5,669
Exercised during the year	(7,240)	(2,495)
Expired during the year	(1,523)	(538)
Outstanding at the end of the year	20,952	25,608
Exercisable at the end of the year	963	-

26. Share-based payments (continued)

Cash-settled options

	2007 Number of shares '000	2006 Number of shares '000
Outstanding at the beginning of the year	12,701	21,389
Converted during the year	-	(5,669)
Exercised during the year	(4,053)	(2,188)
Expired during the year	(699)	(831)
Outstanding at the end of the year	7,949	12,701

No options were exercisable at the end of the year.

	2007		2006	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	4	4	5	4
Weighted average fair value of options granted (£)	2.29	-	1.88	-
Expense recognised for the year (£m)	7	18	8	22

The exercise price for the PSP is £nil (2006 £nil).

Restricted Share Plan (RSP)

All awards are equity-settled.

	2007 Number of shares '000	2006 Number of shares '000
Outstanding at the beginning of the year	1,338	1,047
Granted during the year	-	303
Exercised during the year	(619)	(9)
Expired during the year	(116)	(3)
Outstanding at the end of the year	603	1,338
Exercisable at the end of the year	-	-

	2007	2006
Weighted average remaining contracted life (years)	1	1
Weighted average fair value of options granted (£)	-	3.89
Expense recognised for the year (£m)	1	1

The exercise price for the RSP is £nil (2006 £nil).

Share Matching Plan (SMP)

All awards are equity-settled.

	2007 Number of shares '000	2006 Number of shares '000
Granted during the year	464	-
Expired during the year	(1)	-
Outstanding at the end of the year	463	-
Exercisable at the end of the year	-	-

	2007	2006
Weighted average remaining contracted life (years)	2	-
Weighted average fair value of options granted (£)	4.59	-
Expense recognised for the year (£m)	-	-

The exercise price for the SMP is £nil.

Notes to the Group accounts (continued)

26. Share-based payments (continued)

Save-As-You-Earn (SAYE)

Equity-settled options

	2007		2006	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	21,174	1.71	33,651	1.80
Exercised during the year	(10,873)	2.10	(11,215)	1.96
Expired during the year	(824)	1.64	(1,262)	1.74
Outstanding at the end of the year	9,477	1.25	21,174	1.71
Exercisable at the end of the year	157	1.62	128	1.74

Cash-settled share appreciation rights

	2007		2006	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	8,923	2.76	14,388	2.70
Exercised during the year	(3,214)	2.08	(4,361)	2.48
Expired during the year	(555)	3.18	(1,104)	2.91
Outstanding at the end of the year	5,154	3.14	8,923	2.76
Exercisable at the end of the year	1,865	2.40	1,592	1.74

	2007		2006	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	0.93 – 2.56	1.72 – 3.56	0.93 – 3.21	1.72 – 3.56
Weighted average remaining contracted life (years)	1	1	2	2
Expense recognised for the year (£m)	2	7	3	7

Details of options granted in the year

The fair value of equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

PSP – Monte Carlo

RSP – Dividend valuation model

ExSOS & SAYE – Binomial model

	2007	2006
Range of share price at date of grant (£)	4.32 – 4.86	4.18
Exercise price (£)	0 – 4.79	0 – 4.28
Expected option life (years)	4 – 5	3 – 5
Volatility	25 – 36%	27 – 38%
Spot dividend yield	2.5 – 2.8%	2.5%
Risk free interest rate	5.0 – 5.3%	4.4%

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £4.52 (2006 £3.96).

The liability in respect of the cash-settled elements of the schemes shown above and reported within provisions at 31 December 2007 is £75m (2006 £82m).

The intrinsic value of cash-settled options that have vested at 31 December 2007 is £26m (2006 £14m).

Share Incentive Plan

The Group also incurred a charge of £16m in respect of the all-employee free shares element of the Share Incentive Plan.

27. Reconciliation of movement in capital and reserves

	Attributable to equity holders of the parent							Minority interests £m	Total equity £m
	Issued share capital £m	Share premium £m	Equity option of preference shares £m	Other reserves £m	Retained earnings £m	Total £m			
Balance at 1 January 2006	80	782	78	4,720	(2,872)	2,788	16	2,804	
Total recognised income and expense	-	-	-	(476)	2,177	1,701	3	1,704	
Share-based payments ¹	-	-	-	-	46	46	-	46	
Share options:									
Proceeds from shares issued	1	52	-	-	-	53	-	53	
Purchase of own shares by ESOP	-	-	-	-	(12)	(12)	-	(12)	
Conversion of preference shares	-	7	(2)	6	(6)	5	-	5	
Purchase of treasury shares	-	-	-	-	(112)	(112)	-	(112)	
Release of unrealised gain on the sale of Atlas Elektronik	-	-	-	(11)	-	(11)	-	(11)	
Revaluation of net assets acquired by equity accounted investments (note 14)	-	-	-	-	5	5	-	5	
Reclassification	-	-	-	91	(91)	-	-	-	
Other	-	-	-	-	-	-	(2)	(2)	
Ordinary share dividends	-	-	-	-	(346)	(346)	-	(346)	
At 31 December 2006	81	841	76	4,330	(1,211)	4,117	17	4,134	
Total recognised income and expense	-	-	-	72	1,291	1,363	21	1,384	
Placing of shares (net of costs)	5	-	-	-	736	741	-	741	
Share-based payments	-	-	-	-	34	34	-	34	
Share options:									
Proceeds from shares issued	1	63	-	-	-	64	-	64	
Purchase of own shares	-	-	-	-	(50)	(50)	-	(50)	
Conversion of preference shares	3	318	(76)	229	(229)	245	-	245	
Purchase of treasury shares	-	-	-	-	(152)	(152)	-	(152)	
Other	-	-	-	-	-	-	(1)	(1)	
Ordinary share dividends	-	-	-	-	(396)	(396)	(1)	(397)	
At 31 December 2007	90	1,222	-	4,631	23	5,966	36	6,002	

Other reserves include a merger reserve of £4,589m (2006 £4,589m), a statutory reserve of £202m (2006 £202m), a translation reserve of £217m debit (2006 £259m debit) and a hedging reserve of £57m (2006 £27m). Under Section 4 of the British Aerospace Act 1980 the statutory reserve may only be applied in paying up unissued shares of the Group to be allotted to members of the Group as fully paid bonus shares.

1 The credit in respect of share-based payments for the year ended 31 December 2006 comprises £21m in respect of equity-settled share-based payment schemes, £21m relating to a change in the terms of certain share-based payment schemes from cash-settled to equity-settled and £4m relating to discontinued operations.

Placing of shares

On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were issued by a placing of shares (note 25). 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 (note 25).

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 Group 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.

Notes to the Group accounts (continued)

28. Reconciliation of operating business cash flow

	2007 £m	Restated ¹ 2006 £m
Cash inflow from operating activities	2,162	778
Purchases of property, plant and equipment	(307)	(419)
Additions to intangible assets	(31)	(27)
Equity accounted investment funding	(4)	–
Proceeds from the sale of property, plant and equipment	13	135
Proceeds from the sale of investment property	53	174
Proceeds from the sale of non-current other investments	15	1
Purchase of non-current other investments	(1)	(5)
Dividends received from equity accounted investments	78	145
Operating business cash flow	1,978	782
Electronics, Intelligence & Support	302	273
Land & Armaments	10	137
Programmes & Support	807	449
International Businesses	678	171
HQ & Other Businesses	181	(225)
Discontinued operations	–	(23)
Operating business cash flow	1,978	782

1 business group analysis restated following changes to the Group's organisational structure

29. Net cash/(debt) as defined by the Group

	2007 £m	2006 £m
Term deposits – non-current	–	4
Term deposits – current	164	503
Cash and cash equivalents	3,062	3,100
	3,226	3,607
Loans – non-current	(2,197)	(2,776)
Loans – current	(283)	(308)
Overdrafts – current	(16)	(26)
Loans and overdrafts – current	(299)	(334)
Cash received on customers' account ¹ (included within payables)	(30)	(62)
	(2,526)	(3,172)
Closing net cash as defined by the Group	700	435

Movement in net cash/(debt) as defined by the Group

	2007 £m	2006 £m
Operating business cash flow	1,978	782
Interest and preference dividends	(65)	(207)
Taxation	(112)	(85)
Free cash inflow	1,801	490
Acquisitions and disposals	(1,574)	1,330
Debt acquired on acquisition of subsidiary undertaking	(538)	–
Proceeds from issue of share capital	805	53
Equity dividends paid	(396)	(346)
Dividends paid to minority interests	(1)	–
Preference share conversion	245	6
Other non-cash movements	57	(11)
Purchase of treasury shares	(152)	(112)
Purchase of own shares	(50)	(12)
Foreign exchange	36	323
Movement in cash received on customers' account ¹	32	(9)
Movement in net cash as defined by the Group	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

1 cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payments guarantees unrelated to company performance

29. Net cash/(debt) as defined by the Group (continued)

Cash flows in relation to acquisitions and disposals

	Subsidiaries						Equity accounted investments			
	Armor Holdings £m	Other acquisitions ² £m	Total acquisitions £m	Inertial Products £m	SELEX £m	Other disposals ² £m	Total disposals £m	XPS/XHRS £m	Other £m	Total £m
Cash (consideration)/proceeds	(1,696)	(9)	(1,705)	65	24	7	96	57	(1)	(1,553)
Transaction costs incurred by acquiree	(26)	–	(26)	–	–	–	–	–	–	(26)
	(1,722)	(9)	(1,731)	65	24	7	96	57	(1)	(1,579)
Cash and cash equivalents net of overdrafts acquired/(disposed)	6	–	6	(1)	–	–	(1)	–	–	5
Acquisitions and disposals	(1,716)	(9)	(1,725)	64	24	7	95	57	(1)	(1,574)
Debt acquired on acquisition of subsidiary	(538)	–	(538)	–	–	–	–	–	–	(538)
	(2,254)	(9)	(2,263)	64	24	7	95	57	(1)	(2,112)

2 other acquisitions and disposals are described in notes 31 and 9, respectively

30. Dividends

	2007 £m	2006 £m
Equity dividends		
Prior year final 6.9p dividend per ordinary share paid in the year (2006 6.3p)	221	203
Interim 5.0p dividend per ordinary share paid in the year (2006 4.4p)	175	143
	396	346

After the balance sheet date, the directors proposed a final dividend of 7.8p (2006 6.9p). The dividend, which is subject to shareholder approval, will be paid on 2 June 2008 to shareholders registered on 18 April 2008. The ex-dividend date is 16 April 2008.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 9 May 2008.

31. Acquisition of subsidiaries

The Group made a number of acquisitions during the year, the most significant of which was of Armor Holdings, Inc. in the US. The acquisitions took place throughout the year, but if they had occurred on 1 January 2007, combined sales of Group and equity accounted investments would have been £17.4bn, revenue £16.0bn and profit for the year from continuing operations £946m.

Armor Holdings, Inc.

On 31 July 2007, the Group acquired 100% of the issued share capital of Armor Holdings, Inc. (Armor), in the US, for a consideration of £1,696m, excluding transaction costs incurred by the acquiree (£26m). Goodwill arising on consolidation amounted to £1,554m. Armor is a major manufacturer of tactical wheeled vehicles and a leading provider of vehicle and individual armour systems and survivability technologies for the military and for the law enforcement and commercial security markets.

In the period from acquisition to 31 December 2007, Armor contributed EBITA¹ of £77m and profit after tax of £18m to the Group's consolidated results.

Mobile International, a subsidiary of Armor, was acquired with a view to immediate resale. Accordingly, it has been classified as held for sale in the acquisition balance sheet and as at 31 December 2007 (note 19).

The acquisition of Armor complements the existing US business in the Land & Armaments business group creating synergy potential. It allows for continued development of the Mine Resistant Ambush Protected (MRAP) vehicles and Family of Medium Tactical Vehicles (FMTV) programmes, as well as advanced ceramics for body armour. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within the Land & Armaments business group supporting the recognised goodwill.

Certain of the fair values assigned to the net assets acquired are provisional. These will be amended as necessary in light of subsequent knowledge or events to the extent that these reflect conditions as at the date of acquisition.

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

Notes to the Group accounts (continued)

31. Acquisition of subsidiaries (continued)

The acquisition had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	172	–	581	753
Property, plant and equipment	85	(1)	8	92
Inventories	163	(5)	(4)	154
Receivables	158	(1)	(1)	156
Current tax receivable	33	–	2	35
Deferred tax assets	23	3	–	26
Payables	(204)	(1)	(20)	(225)
Deferred tax liabilities	(87)	–	(145)	(232)
Retirement benefit obligations	(24)	4	(2)	(22)
Provisions	(13)	–	(57)	(70)
Cash and cash equivalents	6	–	–	6
Loans	(386)	(5)	(147)	(538)
Held for sale	14	–	(7)	7
Net (liabilities)/assets acquired	(60)	(6)	208	142
Goodwill				1,554
Consideration				1,696
Consideration satisfied by:				
Cash				1,682
Directly attributable costs:				
Paid				14
Accrued				–
				1,696

The intangible assets acquired as part of the acquisition of Armor can be analysed as follows:

	£m
Programmes	551
Customer relationships	129
Trademarks	69
Patents	4
	753

Other acquisitions

Other acquisitions include the acquisition of Pitch Technologies AB and iSC for a consideration of £5m and £4m, respectively. In each case, 100% of the shares were acquired. As a result of these acquisitions, an additional £9m of goodwill was generated in the year.

During 2006, the Group acquired 100% of the shares of National Sensor Systems, LLC. for £5m in cash and paid deferred consideration of £7m in respect of its acquisition, in May 2005, of OMC Group.

32. Financial risk management

A discussion of the Group's treasury objectives and policies and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net debt (note 29) together with other financial assets and other financial liabilities (note 17) and other instruments deemed to be financial instruments under IAS 32 including non-current receivables, non-current payables and non-current provisions.

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Foreign exchange contracts								
Net forward (sales)/purchase contracts								
US dollar	(2,366)	141	(12)	(2,237)	(1,498)	25	(38)	(1,511)
Euro	1,277	425	(1)	1,701	643	10	3	656
Other	131	3	-	134	36	2	-	38
	(958)	569	(13)	(402)	(819)	37	(35)	(817)

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate contracts								
Interest rate swap contracts								
US dollar	-	654	-	654	128	664	-	792
Sterling	30	120	31	181	26	99	53	178
	30	774	31	835	154	763	53	970

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cross-currency swap contracts								
Net forward (sales)/purchase contracts								
US dollar	38	176	339	553	143	252	301	696
Swedish krona	(143)	-	-	(143)	-	(137)	-	(137)
	(105)	176	339	410	143	115	301	559

Fair value of financial instruments

The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates;
- the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

Notes to the Group accounts (continued)

32. Financial risk management (continued)

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date¹.

	Net carrying amount 2007 £m	Estimated fair value 2007 £m	Net carrying amount 2006 £m	Estimated fair value 2006 £m
Assets				
Non-current				
Other investments	-	-	4	4
Other receivables ²	265	265	569	569
Other financial assets	48	48	51	51
Current				
Other investments	164	164	503	503
Other financial assets	101	101	50	50
Cash and cash equivalents	3,062	3,062	3,100	3,100
Liabilities				
Non-current				
Loans	(2,197)	(2,399)	(2,776)	(2,964)
Other financial liabilities	(26)	(26)	(45)	(45)
Current				
Loans and overdrafts	(299)	(308)	(334)	(339)
Other financial liabilities	(71)	(71)	(50)	(50)

1 the estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date

2 net carrying amount approximates to estimated fair value as there is no active market

Interest rate risk

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	Beyond 2012 £m
Assets						
Non-current						
Other receivables	109	-	-	-	-	-
Current						
Other investments	164	-	-	-	-	-
Cash and cash equivalents	3,062	-	-	-	-	-
Liabilities						
Non-current						
Loans	(577)	(577)	(545)	(263)	(127)	(94)
Current						
Loans and overdrafts	(41)	-	-	-	-	-

Collateral

As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2007 totalled £109m (2006 £115m).

Committed undrawn borrowing facilities

At 31 December 2007 the Group had a committed Revolving Credit Facility (RCF) of £1.5bn, which expires in more than two years but less than five years (2006 £1.5bn which expires in more than two years but less than five years). The RCF was originally contracted for five years until 2010. However, it has been extended by the agreement of two one-year extensions 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.

32. Financial risk management (continued)

Interest rate fluctuations

The objective of interest rate risk management is to reduce the exposure to interest rate fluctuations on borrowings and deposits. This is achieved through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps. The Group's current interest rate management policy is that a minimum of 25% (2006 25%) and a maximum of 75% (2006 75%) of debt is maintained at fixed interest rates. At 31 December 2007, the Group had 75% (2006 72%) of fixed rate debt and 25% (2006 28%) of floating rate debt based on a gross debt of £2.5bn (2006 £3.1bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2007, the Group had a total of \$1.3bn (2006 \$1.6bn) of this type of swap outstanding with a weighted average duration of 3.2 years (2006 3.6 years). In respect of the fixed rate debt the weighted average period in respect of which interest is fixed was seven years (2006 six years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 6.7%, with 6.3% on US dollars and 7.3% on sterling (2006 both 5.8%). The cost of the fixed rate debt was 7.1% (2006 7.0%). A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £7m (2006 £11m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £23m (2006 £15m).

Credit risk on cash and cash equivalents

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. BAE Systems has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2007 of £3,062m (2006 £3,100m) was invested with 26 (2006 45) financial institutions. The system assigns a maximum exposure based on the counterparty's size, FT composite rating and Credit Default Swap price. These limits are regularly monitored and updated. The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 3% of the balance (2006 4%).

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has negligible exposure to price risk.

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures. Further explanation is set out in the Risk management and principal risks section of the Directors' report on page 50.

33. Related party transactions

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 64 to 83 and in note 7), its equity accounted investments (note 14) and the pension plans (note 22).

Transactions occur with the equity accounted investments in the normal course of business and are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

For the year ended 31 December 2007

Related party	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m	Lease income/(expense) with related party £m	Other £m
Eurofighter Jagdflugzeug GmbH	1,063	-	107	-	-	-
Flagship Training Limited	-	1	-	7	-	-
Fleet Support Limited	1	2	1	-	-	-
Gripen International KB	-	-	109	136	-	-
MBDA SAS	143	11	20	709	2	-
Panavia Aircraft GmbH	71	132	1	-	-	-
Saab AB	3	-	-	-	-	1
CTA International SAS	-	2	-	-	-	-
Flight Control System Management GmbH	-	-	1	1	-	-

Notes to the Group accounts (continued)

33. Related party transactions (continued)

For the year ended 31 December 2006

Related party	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m	Lease income/(expense) with related party £m	Other £m
Airbus SAS ¹	50	–	–	–	15	–
Eurofighter Jagdflugzeug GmbH	1,212	–	97	66	–	–
Flagship Training Limited	–	2	–	16	–	–
Fleet Support Limited	1	8	–	2	–	–
Gripen International KB	–	–	103	115	–	–
MBDA SAS	124	12	14	482	2	–
Panavia Aircraft GmbH	75	53	2	–	–	–
Saab AB	4	2	–	–	–	1
CTA International SAS	1	–	–	–	–	–
Silicon Sensing Systems	–	–	–	7	–	–
Xchanging Procurement Services ²	16	101	2	2	–	–
Xchanging HR Services ²	–	26	–	2	–	–

1 transactions up to the date of disposal

2 no transactions with Xchanging Procurement Services and Xchanging HR Services are reported during 2007 as the effective date of the disposal of the Group's interest in these entities was 1 January 2007

34. Group entities

Principal subsidiary entities	Principal activities	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited (Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)	Defence and commercial aerospace activities	UK	England and Wales
BAE Systems Australia Limited (Held via BAE Systems Australia Holdings Limited)	Defence support and avionics	Australia	Australia
BAE Systems Electronics Limited (Held via Meslink Limited)	Naval prime contracting	UK	England and Wales
BAE Systems Marine Limited (Held via BAE Systems Marine (Holdings) Limited)	Shipbuilding	UK	England and Wales
BAE Systems Integrated System Technologies Limited (Held via BAE Systems Electronics Limited)	Defence systems	UK	England and Wales
BAE Systems Inc. (Held via BAE Systems Holdings Inc.)	Defence systems	US	US
BAE Systems AH Inc. (formerly Armor Holdings, Inc.) (Held via BAE Systems Inc.)	Manufacture of military vehicles and supply of vehicle and armour systems	US	US
BAE Systems Land & Armaments Inc. (Held via BAE Systems Inc.)	Manufacture and support of military vehicles and ship repair	US & Sweden	US
BAE Systems Land Systems (Munitions & Ordnance) Limited (Held via BAE Systems (Holdings) Limited)	Manufacture of ammunition and weapon systems	UK	England and Wales
BAE Systems Land Systems (Weapons & Vehicles) Limited (Held via BAE Systems Land Systems (Finance) Limited and Alvis Limited)	Design, manufacture, supply and support of armoured vehicles	UK	England and Wales
BAE Systems Surface Fleet Solutions Limited (Held via BAE Systems Surface Fleet Solutions (Holdings) Limited)	Shipbuilding	UK	England and Wales
Alvis Limited (Held via BAE Systems (Holdings) Limited)	Manufacture and support of military vehicles	UK	England and Wales

The above list sets out the principal subsidiaries within the Group accounts. It does not represent a full list of subsidiaries. All holdings represent 100% of ordinary share capital.

35. Events after the balance sheet date

In January 2008, BAE Systems entered into an agreement to acquire Tenix Defence, a leading Australian defence contractor, for up to A\$775m (£342m) in cash. The acquisition of Tenix Defence will more than double BAE Systems' presence in Australia making it the largest in-country defence supplier to the Australian Defence Force.