

Risk management and principal risks

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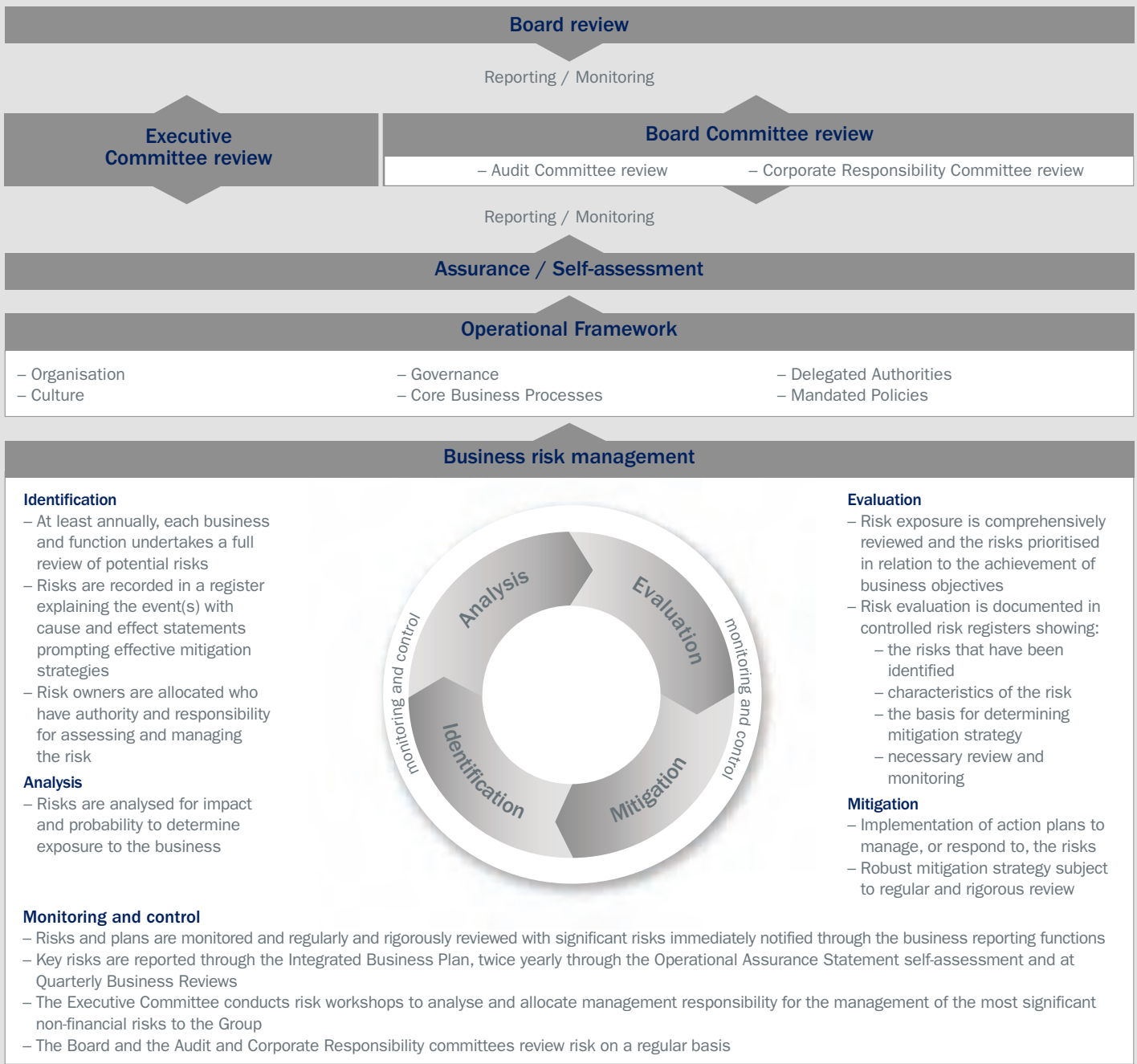
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Risk management within BAE Systems



Group management of risks

Effective management of risk and opportunity is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value and protection of its reputation. The Group's approach to risk management is to remove or reduce the likelihood and effect of risks before they occur, and deal effectively with problems if they arise. The Group is committed to the protection of its assets, which include human, property and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The management of risk is linked into the Group's strategy, the environment in which it operates, the Group's appetite for risk and the delivery of the Group's business objectives. The underlying principles are that risks are continuously monitored, associated action plans reviewed, appropriate contingencies are provisioned and this information is reported through established management control procedures.

To enable this process, BAE Systems has developed a system of internal control, the 'Operational Framework' (OF), that encompasses, amongst other things, the mandated policies and core business processes that provide a common framework for how we do business and what it means to be part of BAE Systems.

The Board has overall responsibility for ensuring that risk is effectively managed across the Group and has delegated to the Audit Committee the responsibility for reviewing in detail the effectiveness of the Group's system of internal controls. During the year, the Executive Committee has further enhanced its oversight of material non-financial risks including, in particular, those arising in connection with safety and ethical issues. Close attention has been paid to analysing risks associated with the conduct of international business and new policies and processes have been implemented seeking to provide the highest levels of assurance. The Executive Committee advises the Corporate Responsibility Committee of all matters within the latter's remit.

In order to assist the Committees and the Board in their review, the Group has a self-assessment Operational Assurance Statement (OAS) process. The OAS is in two parts: a self-assessment of compliance with appropriate parts of the OF; and a report showing the key risks for the relevant business. Together with independent reviews undertaken by Internal Audit, and the work of the external auditors, the OAS forms the Group's process for reviewing the effectiveness of the system of internal controls.

Reporting within the Group is structured so that key issues are escalated through the management team, ultimately to the Board if appropriate. The responsibility for risk identification, analysis, evaluation, mitigation, reporting and monitoring rests with line management. Both the Audit Committee and the Corporate Responsibility Committee report the findings of their reviews to the Board so that the Board can form a view.

Further information on the activities of the Board and its Committees is given in the Corporate governance section on pages 54 to 63 of this report.

Five core processes and 27 policies are mandated by the OF, enabling the business to respond appropriately to material risks faced by the Group. As with any system of internal control, the policies and processes that are mandated in the OF are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable, and not absolute, assurance against material misstatement or loss.

Further detail on these business processes and mandated policies is given in the Internal control section of the Corporate governance section on page 60.



Internal Audit
Internal Audit independently reviews the risk identification procedures and control processes implemented by management.

Risk management and principal risks (continued)

Summary of principal risks

Defence spending

The Group is dependent on defence spending and reductions in such spending could adversely affect the Group.

The Group's core businesses are primarily defence-related, selling products and services directly and indirectly primarily to the US, the UK, the Saudi Arabian and other national governments. In any single market, defence spending depends on a complex mix of political considerations, budgetary constraints and the ability of the armed forces to meet specific threats and perform certain missions. Because of these factors, defence spending may be subject to significant fluctuations from year to year.

Although the Group expects growth in US defence spending to slow, it believes it is well placed to support the US Department of Defense's likely emphasis on force sustainment, readiness and affordable transformation. The UK defence equipment budget is expected to continue to be constrained, having potential implications for the sustainability of long-term funding for future defence technologies and engineering capabilities in the UK.

Impact

A decrease in defence purchases by the Group's major customers could have a material adverse effect on the Group's future results of operations and financial condition.

Certain parts of the Group's business are dependent on a small number of large contracts.

A significant proportion of the Group's revenue comes from a small number of large contracts. These contracts individually are typically worth or potentially worth £1bn or more including, but not limited to, those contracts in the Programmes & Support business group.

Impact

The loss, expiration, suspension, cancellation or termination of any one of these contracts, for any reason, could have a material adverse effect on the Group's future results of operations and financial condition.

The Group's largest customer contracts are government contracts.

The governments of the United Kingdom, the United States and the Kingdom of Saudi Arabia are the Group's three largest end customers. Any significant disruption or deterioration in the relationship with these governments and a corresponding reduction in government contracts would significantly reduce the Group's revenues. Moreover, companies engaged in the supply of defence-related equipment and services to government agencies are subject to certain business risks particular to the defence industry. These governments could unilaterally cancel, suspend or amend their contractors' funding under existing contracts or eligibility for new contracts potentially at short notice. Terms and risk sharing agreements can also be amended. In addition, the Group, as a government contractor, is subject to financial audits and other reviews by some of its governmental customers with respect to the performance of, and the accounting and general practices relating to, government contracts. As a result of these audits and reviews, costs and prices under these contracts may be subject to adjustment.

Impact

The termination of one or more of the contracts for the Group's programmes by governments, or the failure of the relevant agencies to obtain expected funding appropriations for the Group's programmes, could have a material adverse effect on the Group's future results of operations and financial condition.

The timing of contracts could materially affect the Group's future results of operations and financial condition.

The Group's operating performance and cash flows are dependent, to a significant extent, on the award of defence contracts and its performance in delivering these contracts.

Impact

Because the amounts payable under these contracts can be substantial, the award or completion of one or more contracts, the timing for manufacturing and delivery of products under these contracts or the failure to receive anticipated orders could materially affect the Group's operating results and cash flow for the periods affected.

Action

The Board regularly reviews the Group's performance in these markets, and the Executive Committee continues to work closely with customers to ensure the Group strategy is aligned with theirs (refer to the strategy section on page 12).

Fixed-price contracts

The Group has fixed-price contracts.

A significant portion of the Group's revenues are derived from fixed-price contracts, although the Group has reduced its exposure to fixed-priced design and development activity which is in general more risk intensive than fixed-price production activity. An inherent risk in these fixed-price contracts is that actual performance costs may exceed the projected costs on which the fixed prices for such contracts are agreed.

Impact

The Group's failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-priced contract may reduce the profitability of such a contract or result in a loss.

Action

To manage contract-related risks and uncertainties, contracts are managed through the application of the Group's mandated Lifecycle Management (LCM) business process at the operational level and the consistent application of metrics is used to support the review of individual contract performance (refer to page 52 for further information on LCM).

Global market

The Group is exposed to risks inherent in operating in a global market.

BAE Systems is a global company which conducts business in a number of regions, including the Middle East, and, as a result, assumes certain risks associated with businesses with a broad geographical reach. In some countries these risks include, and are not limited to, the following: government regulations and administrative policies could change quickly and restraints on the movement of capital could be imposed; governments could expropriate the Group's assets; burdensome taxes or tariffs could be introduced; political changes could lead to changes in the business environment in which the Group operates; and economic downturns, political instability and civil disturbances could disrupt the Group's business activities.

Impact

The occurrence of any such events could have a material adverse effect on the Group's future operational performance and financial condition.

Action

The Group has a balanced portfolio with six home markets.

Export controls and other restrictions

The Group is subject to export controls and other restrictions.

A portion of the Group's sales is derived from the export of its products. Many of the products the Group designs and manufactures for military or dual use are considered to be of national strategic interest. The export of such products outside of the jurisdictions in which they are produced is normally subject to licensing and export controls and other restrictions. No assurance can be given that the export controls to which the Group is subject will not become more restrictive, that new generations of the Group's products will not also be subject to similar or more stringent controls, or that political factors or changing international circumstances will not result in the Group being unable to obtain necessary export licences.

Impact

Reduced access to export markets could have a material adverse effect on the Group's future results of operations and financial condition.

Failure to comply with export controls and wider regulations could expose the Group to fines and other penalties, including potential restrictions on trading.

Action

The Group has formal systems and policies in place to ensure adherence to regulatory requirements and to identify any restrictions that could adversely impact the Group's future activities.

Risk management and principal risks (continued)

Competition

The Group's business is subject to significant competition.

Most of the Group's businesses are focused on the defence industry and subject to competition from multinational firms with substantial resources and capital and many contracts are obtained through a competitive bidding process. The Group's ability to compete for contracts depends to a large extent on the effectiveness and innovation of its research and development programmes, its ability to offer better programme performance than its competitors at a lower cost to its customers, and the readiness of its facilities, equipment and personnel to undertake the programmes for which it competes.

Additionally, in some instances, governments direct to a single supplier all work for a particular programme, commonly known as a sole-source programme. Although governments have historically awarded certain programmes to the Group on a sole-source basis, they may in the future determine to open such programmes to a competitive bidding process.

Government contracts for defence-related products can, in certain countries, be awarded on the basis of home country preference. Therefore, other defence companies may have an advantage over the Group for some defence-related contracts on the basis of the jurisdiction in which they are organised, where the majority of their assets are located or where their officers or directors are located.

Impact

In the event that the Group is unable adequately to compete in the markets in which it operates, the Group's business and results of operations may be adversely affected.

Action

The Group's strong global market positioning, balanced portfolio, leading capabilities and performance continue to address this risk (refer to page 12 for further information on the Group's positioning and portfolio).

Consortia and joint ventures

The Group is involved in consortia, joint ventures and equity holdings where it does not have control.

The Group participates in various consortia, joint ventures and equity holdings, exercising varying and evolving degrees of control. While the Group seeks to participate only in ventures in which its interests are aligned with those of its partners, the risk of disagreement is inherent in any jointly controlled entity, and particularly in those entities that require the unanimous consent of all members with regard to major decisions, and that specify restricted rights.

Impact

In the event of disagreement within a consortia, joint venture or equity holding and the business arrangement fails to meet its strategic objectives or expected benefits, the Group's business and results of operations may be adversely affected.

Action

The Group has formal systems and procedures in place to monitor the performance of such business arrangements and identity and manage any adverse scenario arising.

Pension funding

The Group is exposed to funding risks in relation to the defined benefits under its pension schemes.

The Group operates certain defined benefit pension schemes. At present, in aggregate, there is an actuarial deficit between the value of projected liabilities of these schemes and the value of the assets they hold. The Group has put in place and is implementing deficit recovery plans in line with agreements reached with the respective scheme trustees based on actuarial advice and the valuation results.

Impact

The amount of the deficits may be adversely affected by a number of factors, including lower than assumed investment returns, changes in long-term interest rate and price inflation expectations, and greater than anticipated improvements in members' longevity. An increase in pension scheme deficits may require the Group to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet the Group's other obligations or business needs.

Action

The performance of the Group's pension schemes and deficit recovery plans are regularly reviewed by both the Group and the Trustees of the schemes taking actuarial and investment advice as applicable. The results of these reviews are discussed with the Board and appropriate action taken (refer to page 117 for further details on the Group's retirement benefit plans).

Acquisitions

The Group has experienced growth through acquisitions. Anticipated benefits of acquisitions may not be realised.

The Group has experienced growth through acquisitions and continues to pursue acquisitions in order to meet its strategic objectives. Integrating the operations and personnel of acquired businesses is a complex process. The Group may not be able to integrate the operations of acquired businesses with existing operations rapidly or without encountering difficulties.

Impact

The diversion of management attention to integration efforts and any difficulties encountered in combining operations could adversely affect the Group's business. The failure to manage growth by acquisition while at the same time maintaining adequate focus on the existing assets of the Group, could have a material adverse effect on the Group's business, future results of operations or financial condition.

In addition, failure to integrate acquisitions appropriately creates the risk of impairments arising on goodwill and other intangible assets.

Action

The Group has an established methodology in place to deliver the effective integration of acquisitions.

The Group has an established policy for monitoring impairment risks.

Regional Aircraft

The Group holds a number of regional aircraft on its balance sheet and has provided residual value guarantees in respect of certain regional aircraft sold.

These aircraft are leased, or have been sold, to airline operators.

Impact

Values of regional aircraft are impacted by a range of factors including the financial strength of regional aircraft operators, market demands for regional aircraft and the impact of economic factors on aircraft operating costs.

Reductions in the valuations of these aircraft could result in impairment charges against the carrying value of the aircraft or additional provisions against the guarantees given.

Action

The Group's primary action is to operate an efficient asset management organisation.

Much of the leasing business was underpinned by the Group's Financial Risk Insurance Programme, which makes good shortfalls in actual lease income against originally estimated future income for a 15-year period from 1998 to 2013. Since 2006 BAE Systems and the reinsurers have been in dispute over several areas of the policy. During 2007, agreement was reached with almost all reinsurers and settlements have been paid by them based on the net present value of estimated future claims.

Arbitration proceedings are ongoing in relation to several claims advanced by one reinsurer who has a maximum potential liability under the policy of \$145m. These claims are being vigorously defended.

Risk management and principal risks (continued)

Laws and regulations

The Group is subject to risk from a failure to comply with laws and regulations.

The Group's operations are subject to numerous domestic and international laws, regulations and restrictions. Non-compliance with these laws, regulations and restrictions could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group.

The Group has contracts and operations in many parts of the world and operates in a highly regulated environment. The Group is subject to the laws and regulations of many jurisdictions, including those of the UK and US. These include, without limitation, regulations relating to import-export controls, money-laundering, false accounting, anti-bribery and anti-boycott provisions. From time to time, the Group is subject to government investigations relating to its operations.

Impact

Failure by the Group or its sales representatives, marketing advisers or others acting on its behalf to comply with these laws and regulations could result in administrative, civil or criminal liabilities resulting in significant fines and penalties and/or result in the suspension or debarment of the Group from government contracts for some period of time or suspension of the Group's export privileges.

Action

During the year, the Group has devoted additional resource and further enhanced its mandated procedures designed to ensure compliance with its policies relating to the conduct of international business. The Executive Committee maintains a list of approved export markets arrived at on the basis of a market risk assessment utilising input from externally developed risk assessments. A panel of experts scrutinises all adviser appointments within the Group. Findings of the panel of experts are reviewed by members of the Executive Committee and material market or programme risks are discussed by the Board.

The investigation by the Serious Fraud Office into suspected false accounting and corruption is continuing and the Group continues to co-operate with this investigation. In June 2007, the Company was notified by the US Department of Justice 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.

Exchange rates

The Group is exposed to volatility in currency exchange rates.

The global nature of the Group's business means it is exposed to volatility in currency exchange rates in respect of foreign currency denominated transactions, and the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

Impact

Significant fluctuations in exchange rates to which the Group is exposed could have a material adverse effect on the Group's future results of operations and financial condition.

Action

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved as an exception by the Treasury Review Management Committee, as well as to manage anticipated economic cash flow exposures over the medium term. The Group aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material foreign currency exposures.

The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long term or core to the Group.

Additional risks and uncertainties currently unknown to the Group, or which the Group currently deems immaterial, may also have an adverse effect on the financial condition or business of the Group.