



Interim Report 2002

BAE SYSTEMS

The systems company innovating for a safer world

Systems that extract the right information and convey it to the right people in even the most difficult terrain

Overview

- Performance in the first six months supports our plans for the full year.
- Interim dividend increased by 5.7%.
- Strong performance from our North America and Customer Solutions & Support business groups and at Airbus, together with an improving position in our Air Systems activities, enables us to maintain our plan for 2002 despite pressures elsewhere in the company.
- We continue to plan for a resumption of growth in 2003, although we face a number of challenges.
- Outlook depends on the impact of the change in programme emphasis as a result of the New Chapter to the Strategic Defence Review, which places greater emphasis on Network Centric Capabilities. As the creation of our C4ISR³ business demonstrates, we see this as a major growth area and opportunity for the company.
- Order book¹ **£42.9bn**
- Sales **£5,703m**
- Profit before interest² **£461m**
- Earnings per share² **7.7p**
- Dividend per share **3.7p**
- Operating cash outflow **£262m**
- Net debt **£1,551m**

¹ including joint ventures and after the elimination of inter-business group orders

² before goodwill amortisation and exceptional items

³ Command, Control, Communication and Computing, Intelligence, Surveillance and Reconnaissance



The first half performance demonstrates the resilience of BAE SYSTEMS in a period where we have had to address a number of unforeseen issues.

Strong performance from our North America and Customer Solutions & Support business groups and at Airbus, together with an improving position in our Air Systems activities, enables us to maintain our plan for 2002 despite pressures elsewhere in the company.

To complement our strong presence in Europe, we continue to seek to expand our position in North America, which is where we see most opportunity for significant growth. In pursuit of this strategy, we recently embarked on a bid for the defence businesses of TRW. Whilst unsuccessful, we gained valuable experience from the process and we shall continue to look at value enhancing opportunities to develop our North America business group as they arise.

We continue to plan for a resumption of growth in 2003, although we face a number of challenges. In particular, the outlook depends on the impact of the change in programme emphasis as

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a result of the New Chapter to the Strategic Defence Review, which places greater emphasis on Network Centric Capabilities. As the creation of our C4ISR business demonstrates, we see this as a major growth area and opportunity for the company.

We have also seen a reshaping of our senior management team. As chief executive, Mike Turner brings his own skills and strengths to the role, building on John Weston's good work. We have recently appointed two new executive directors. Following HM Government's relaxation of nationality controls, Mark Ronald, a US citizen and president of our North America business group, joined the board in May. Chris Geoghegan, chief operating officer, joined the board in June.

The abilities and dedication of every member of BAE SYSTEMS has ensured that we have achieved the progress made over the first half year, and I am grateful for the team's commitment.



Sir Richard Evans

Chairman

11 September 2002

Chief executive's review



Performance in the first six months supports our plans for the full year, despite some change in the mix of contributions from the businesses. We anticipate a stronger performance in the second half year.

In the Programmes business group, military aircraft activities responded to the remedial actions taken in 2001, but progress here was more than offset by significant short-term challenges in certain residual UK shipbuilding programmes that incurred contract losses in the first half. We see a positive future for our Air and Sea Systems businesses, supported by strong order books leading to a commensurate increase in activity.

Our Customer Solutions & Support business group has performed strongly. Activity on established support packages remains high and we have been awarded a number of longer-term integrated platform support packages on Tornado aircraft. Similar plans are being developed across other in-service platforms as we support the drive of the UK Defence Logistics Organisation for cost efficiencies. Other notable highlights included an 11 year extension to our partnership with the Royal Navy at the Portsmouth naval base.

The performance of a number of our International Partnerships continued to be disappointing, particularly the Astrium space systems joint venture where losses have increased. Disposal of our interest in Astrium was announced in July and we expect to complete this transaction by the end of the year. Notwithstanding the disposal of our interest in Astrium, which is subject to the satisfaction of a number of conditions, sales in the second half will be significantly higher across the remaining International Partnerships businesses, most notably at MBDA where around 75% of the year's sales are planned for the second half.

The Avionics business group profitability for the first half has been negatively impacted by one-off charges associated with two contracts, primarily related to equipment delivery delays, together with restructuring costs. Sales at Avionics increased by 6% during the first half and, as last year, will be skewed to the second half. Deliveries of radar sets and Defensive Aids Sub-Systems (DASS) for Eurofighter Typhoon are planned to be significantly higher in the second half and will contribute to good sales growth for 2002.

Our North America business group continues to perform well. The reported sales growth was 5%. However, the first half of 2001 included disposed businesses, and on a like-for-like basis, sales growth was 10% and profit increased by 7%. North America is well positioned to capture more growth from the increasing US defence budgets.

In the Commercial Aerospace business group, our Airbus joint venture has performed ahead of expectations in a difficult market. This underlines our view that this is a high quality business that will deliver longer-term profitable growth. Airbus has benefited from its restructuring last year into an integrated company, and its management team has coped well with the market downturn. Aircraft deliveries in the first half are on track for the planned 300

Summarised profit and loss account

for the full year. A detailed review of airline customer demand has indicated planned deliveries for 2003 at a similar level. However, a number of airlines are experiencing significant financial challenges, and we will continue to monitor the position. Development of the high capacity A380 continues to plan.

Finally, I want to thank the BAE SYSTEMS team for its support in my first few months as chief executive.

Mike Turner

Chief executive

11 September 2002

	Six months to 30 June 2002 Unaudited £m	Six months to 30 June 2001 Unaudited £m	Year to 31 December 2001 Audited £m
Sales	5,703	6,292	13,138
Operating profit ¹	354	393	956
Share of operating profit of joint ventures ¹	107	158	304
Profit before interest¹	461	551	1,260
Net interest	(102)	(69)	(177)
Profit before tax, goodwill amortisation and exceptional items	359	482	1,083
Profit before tax, after goodwill amortisation and exceptional items	41	171	70
Tax	(104)	(142)	(198)
Minority interests	-	(6)	(6)
(Loss)/profit for the period	(63)	23	(134)
Basic earnings per share ¹	7.7p	10.3p	23.4p
Diluted earnings per share ¹	7.7p	10.2p	23.4p
Dividend per share	3.7p	3.5p	9.0p

Business group analysis

	30 June 2002 unaudited				Restated ² 30 June 2001 unaudited			
	Order book £bn	Sales £m	Profit £m	Number of employees ³	Order book £bn	Sales £m	Profit £m	Number of employees ³
Programmes	11.7	955	3	20,000	11.1	1,374	53	21,100
Customer Solutions & Support	2.2	1,065	220	8,800	2.2	1,023	190	10,200
International Partnerships	5.9	658	2	16,400	6.0	799	51	18,000
Avionics	2.7	459	4	10,300	2.7	433	37	10,200
North America	2.4	1,327	115	21,000	2.7	1,264	112	20,400
Commercial Aerospace	19.3	1,389	122	13,000	22.0	1,555	110	14,800
HQ and other businesses	0.9	159	(5)	4,700	0.9	153	(2)	4,800
	45.1	6,012	461	94,200	47.6	6,601	551	99,500
Less: intra-group	(2.2)	(309)			(2.2)	(309)		
Net interest			(102)				(69)	
			359				482	
Goodwill amortisation, including joint ventures			(279)				(246)	
Exceptional items (see note 1)			(39)				(65)	
	42.9	5,703	41		45.4	6,292	171	

¹ before goodwill amortisation and exceptional items

² see note 7

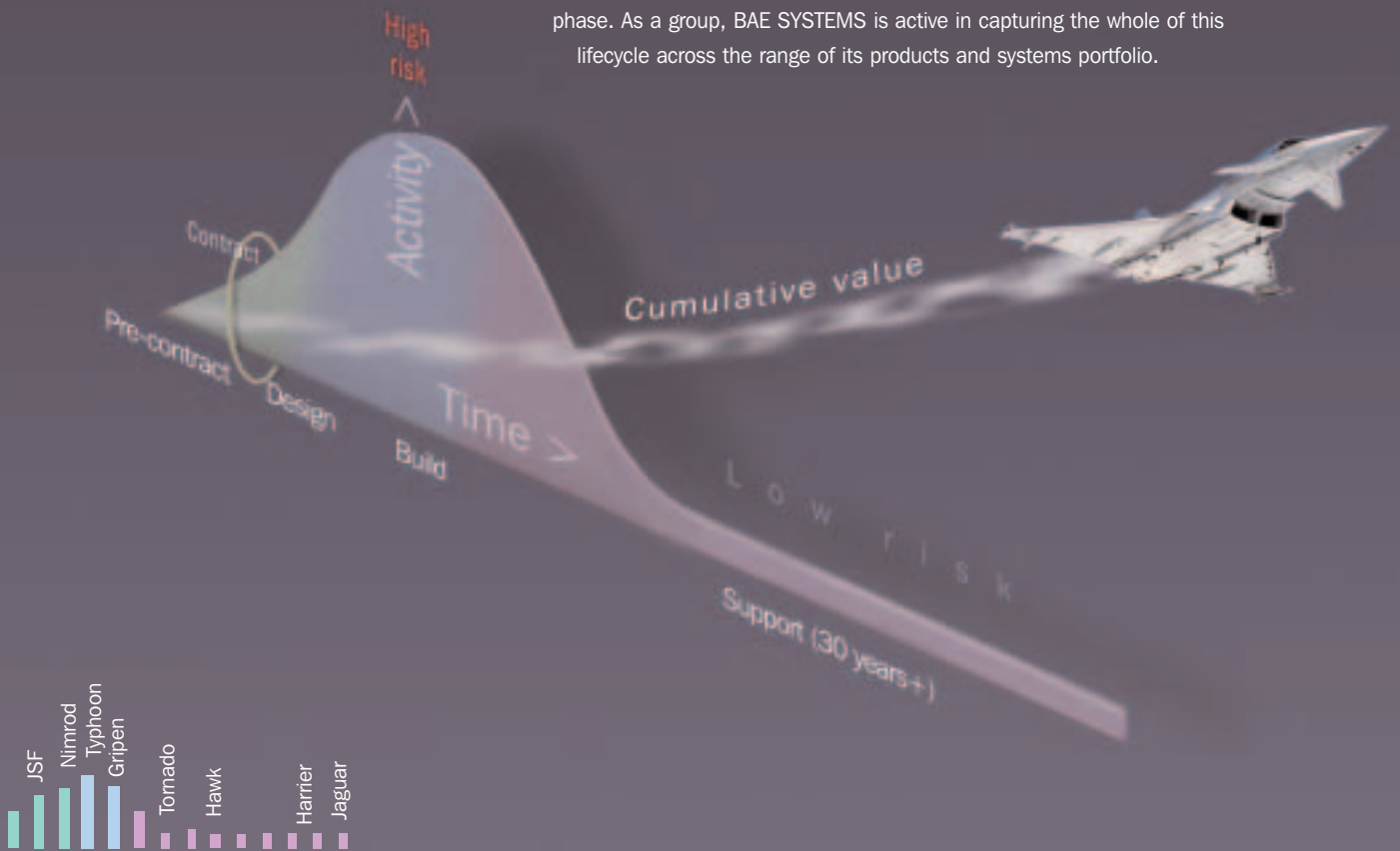
³ includes share of joint venture employees

Project lifecycle

Complex project management is a feature of BAE SYSTEMS business, where multiple products and systems are conceived, designed and developed, managed through to production, and supported in the field. The project lifecycle diagram is a good illustration of the varying degrees of risk and activity at different stages of an individual project's life.

BAE SYSTEMS policy is to have a balanced portfolio of projects that provide a healthy mix of higher risk, medium term investment and development projects, and lower risk well established programmes. Our Air Systems business group is a good example of this, showing a spread of projects at different stages in their lifecycle.

Not to scale, this illustration is generic in application, showing risk and activity typically being higher during the design and initial build stages, than in the longer support phase. As a group, BAE SYSTEMS is active in capturing the whole of this lifecycle across the range of its products and systems portfolio.



A number of major Air Systems programmes are either in development or just entering production, leading to high levels of manufacturing and support activity for many decades.

Business group reviews

Programmes

Despite initial delays in the first flight of the production standard aircraft, Typhoon has progressed well in achieving a high standard of system maturity. Significant development milestones have been achieved resulting in the expansion of the flight performance envelope to meet the aircraft specification, successful firing of a long range air-to-air missile and the inclusion of in-flight refuelling. The first production aircraft are now also contributing to the flight test programme. The Austrian federal government recently selected Typhoon.

The F-35 Joint Strike Fighter (JSF) programme, in which BAE SYSTEMS is a partner with Lockheed Martin and Northrop Grumman, is gathering momentum and we have demonstrated our commitment with a planned £40m investment in manufacturing and assembly facilities.

Turning to other Air Systems programmes, three Nimrod aircraft are in final assembly and first flight will be around the end of the year. The Hawk advanced jet trainer continues to generate interest as an adaptable and cost effective training platform. The Royal Bahraini Air Force recently announced that it had selected Hawk to meet its future training requirements and a number of other opportunities are being pursued.

The Sea Systems activity has been impacted by residual UK shipbuilding programmes. The Auxiliary Oiler and Landing Platform Dock programmes have been challenging, incurring contract losses to completion which have been charged in the first half. The medium and long-term prospects are improved for our next generation naval systems programmes with a strong throughput of activity now in the order book.

Customer Solutions & Support

The CS&S business group has had a strong first half year, with order book, sales and profit ahead of plan. Order intake includes the

extension of the Portsmouth naval base partnering contract for the next 11 years. We have also seen higher than planned levels of orders and sales from the Al Yamamah programme.

Support services are a key element of the company's strategy for growth, and we are pursuing a number of opportunities that will continue to deliver that growth. Our partnership with customers demonstrates our capability to provide integral support to complex solutions and full lifecycle support for our products.

International Partnerships

MBDA has been successfully restructured and now includes our former interests in Matra BAe Dynamics and the guided weapons activities of Alenia Marconi Systems (AMS). The business has built a strong order book but delays in moving the Meteor (beyond visual range air-to-air missile) programme to contract have been experienced. MBDA is expected to show continued improvement from 2003, and the quality of its order book reflects the good prospects of this business over the medium-term.

AMS, also restructured in 2001, has recently won a contract for five new generation 3D long range fixed air defence radar (FADR) systems. A further contract win for the integration of non-defence work in Italy helps to confirm the credentials of the business as a complete systems integrator in air traffic control.

Saab, in which BAE SYSTEMS has a 35% interest, continues to perform satisfactorily. Gripen International, the company formed by BAE SYSTEMS and Saab to market Gripen fighters in export markets, has been successful in winning orders in Hungary. Gripen had been selected in the Czech Republic, although procurement in that country has been postponed as a result of the recent severe flooding.

Earlier this year the space systems joint venture Astrium was selected to supply Skynet 5, the next generation of military communications satellites for the UK MoD. In July, BAE SYSTEMS

agreed the sale of its 27.5% economic interest in Astrium to EADS for €165m. Completion of the Astrium disposal is anticipated by the year end. BAE SYSTEMS will lead the service provision for Skynet 5.

Discussions continue with our partner Rheinmetall in the STN Atlas joint venture to focus our interest on the naval activities within the STN business.

Avionics

The Avionics business group performance has been impacted during the first half by costs associated with delivery delays on certain equipment programmes and restructuring charges. The delayed programmes are now running at the planned rate.

Avionics is a major supplier of sub-systems for the Typhoon programme including the radar and DASS systems. The margins on these contracts remain as previously forecast and underpin a strong margin recovery at Avionics that will be delivered during the second half.

North America

The North America business group continues its track record of strong financial performance. The business is well positioned to participate in the growing US defence market, and in particular the C4ISR sector. The North America business group is a major supplier of airborne avionics and electronic warfare systems.

The launch of the system design and development for the JSF programme, and the launch into low rate initial production of the F-22, represent strong positions on major US airborne systems. The win in the first half of the year of the US Joint Tactical Radio System (JTRS), where we are teamed with Boeing, represents a good example of our ability to team, win and participate in large US defence programmes.

The controls systems activity in the North America business group is a major provider of commercial flight and engine controls. It has experienced some reduction in activity reflecting the downturn in the commercial aircraft market.

Commercial Aerospace

Following the restructuring of Airbus last year, BAE SYSTEMS retains a 20% interest in the Airbus joint venture. Benefiting from this restructuring, Airbus performed well in the half year to June 2002.

Airbus order intake for the first half of the year was 104 aircraft, compared to net orders for the first six months of last year of 260. Reflecting the generally weak airline market, production plans were reduced at the end of 2001 and the company is on track for 300 aircraft deliveries this year with a similar output now planned for 2003. The development of the A380 continues to plan and market interest in this high capacity new aircraft remains strong, with current orders for 95 aircraft.

In addition to its involvement in the Airbus joint venture BAE SYSTEMS retains wholly-owned Aerostructures activities. The Aerostructures business continued to reduce costs to remain competitive in the civil aircraft subcontracting market.

HQ and other businesses

Following a realignment of the company's organisational structure (see note 7) announced in July 2002, the RO Defence business is now reported within HQ and other businesses. RO Defence completed a good half year performance. The company was selected by the UK MoD for the Terrier programme, the next generation air-transportable armoured combat engineer vehicle.

Consolidated profit and loss account

	Six months to 30 June 2002 Unaudited		Six months to 30 June 2001 Unaudited		Year to 31 December 2001 Audited	
	£m	£m	£m	£m	£m	£m
Sales		5,703		6,292		13,138
Less: adjustment for share of joint venture sales		(1,869)		(1,872)		(4,097)
Turnover		3,834		4,420		9,041
Operating costs						
Excluding goodwill amortisation and exceptional items	(3,480)		(4,027)		(8,085)	
Goodwill amortisation	(188)		(197)		(397)	
Exceptional items (see note 1)	(9)		(65)		(136)	
		(3,677)		(4,289)		(8,618)
Operating profit		157		131		423
Share of operating profit of joint ventures						
Excluding goodwill amortisation and exceptional items	107		158		304	
Goodwill amortisation (see note 2)	(91)		(49)		(98)	
Exceptional items (see note 1)	–		–		(12)	
		16		109		194
		173		240		617
Non-operating exceptional item						
Cessation/reorganisation of commercial aerospace activities (see note 1)		(30)		–		(370)
Profit before interest		143		240		247
Excluding goodwill amortisation and exceptional items	461		551		1,260	
Goodwill amortisation	(279)		(246)		(495)	
Exceptional items (see note 1)	(39)		(65)		(518)	
Interest						
Net interest	(94)		(87)		(174)	
Share of net interest of joint ventures	(8)		18		(3)	
		(102)		(69)		(177)
Profit on ordinary activities before taxation		41		171		70
Tax						
Tax on profit excluding exceptional items	(115)		(154)		(346)	
Tax on exceptional items	11		12		148	
		(104)		(142)		(198)
(Loss)/profit on ordinary activities after taxation		(63)		29		(128)
Equity minority interests		–		(6)		(6)
(Loss)/profit for the period		(63)		23		(134)
Dividends						
Equity: ordinary shares (see note 3)	(113)		(107)		(275)	
Non-equity: preference shares	(10)		(10)		(21)	
		(123)		(117)		(296)
Retained loss		(186)		(94)		(430)
Basic earnings per share						
Including goodwill amortisation and exceptional items	(2.4)p		0.4p		(5.1)p	
Excluding goodwill amortisation and exceptional items	7.7p		10.3p		23.4p	
Diluted earnings per share						
Including goodwill amortisation and exceptional items	(2.4)p		0.4p		(5.1)p	
Excluding goodwill amortisation and exceptional items	7.7p		10.2p		23.4p	

All results arise from continuing operations.

Consolidated balance sheet

	Notes	30 June 2002 Unaudited £m	30 June 2001 Unaudited £m	31 December 2001 Audited £m
Fixed assets				
Intangible assets		6,646	7,097	6,909
Tangible assets		1,732	1,844	1,776
Investments				
Share of gross assets of joint ventures		7,122	7,306	7,248
Share of gross liabilities of joint ventures		(5,710)	(6,024)	(5,826)
Share of joint ventures		1,412	1,282	1,422
Others		35	42	35
		1,447	1,324	1,457
		9,825	10,265	10,142
Current assets				
Stocks		1,232	1,340	1,046
Debtors due within one year		2,722	2,289	2,633
Debtors due after one year		706	907	811
Investments	5	934	1,042	1,069
Cash at bank and in hand		641	1,570	1,505
		6,235	7,148	7,064
Liabilities falling due within one year				
Loans and overdrafts		(1,031)	(2,044)	(1,256)
Creditors	6	(5,113)	(5,129)	(5,281)
		(6,144)	(7,173)	(6,537)
Net current assets/(liabilities)				
		91	(25)	527
Total assets less current liabilities				
		9,916	10,240	10,669
Liabilities falling due after one year				
Loans		(2,074)	(1,554)	(2,119)
Creditors	6	(583)	(594)	(611)
		(2,657)	(2,148)	(2,730)
Provisions for liabilities and charges				
	6	(1,048)	(1,138)	(1,281)
		6,211	6,954	6,658
Capital and reserves				
Called up share capital		143	143	143
Share premium account		409	371	374
Statutory reserve		202	202	202
Other reserves	5	5,186	5,440	5,438
Profit and loss account		250	775	481
Shareholders' funds				
Equity: ordinary shares		5,924	6,665	6,372
Non-equity: preference shares		266	266	266
		6,190	6,931	6,638
Equity minority interests				
		21	23	20
		6,211	6,954	6,658

Consolidated cash flow

	Notes	Six months to 30 June 2002 Unaudited £m	Six months to 30 June 2001 Unaudited £m	Year to 31 December 2001 Audited £m
Net cash (outflow)/inflow from operating activities				
Operating profit		157	131	423
Depreciation, amortisation and impairment		292	323	636
Profit on disposal of fixed assets and investments		(12)	(20)	(42)
Movement in provisions for liabilities and charges <i>excluding deferred tax</i>		(294)	(376)	(207)
(Increase)/decrease in working capital				
Stocks		(191)	(494)	(340)
Debtors		(34)	(340)	(716)
Creditors		(273)	446	612
Customer stage payments		93	339	405
		(262)	9	771

Cash flow statement

Net cash (outflow)/inflow from operating activities		(262)	9	771
Dividends from joint ventures		10	10	19
Returns on investments and servicing of finance		(60)	(46)	(210)
Taxation		(9)	1	(94)
Capital expenditure and financial investment		(71)	(83)	(359)
Acquisitions and disposals				
Disposal of subsidiary undertakings and joint ventures		–	82	135
Equity dividends paid		(168)	(158)	(266)
Net cash outflow before financing and management of liquid resources		(560)	(185)	(4)
Management of liquid resources		(113)	125	162
Financing		(91)	298	495
Net (decrease)/increase in cash available on demand		(764)	238	653
Reconciliation of net cash flow to net movement in net funds				
Net (decrease)/increase in cash available on demand		(764)	238	653
Net increase/(decrease) in liquid resources		113	(125)	(162)
Decrease/(increase) in other loans included within net funds		121	(293)	(465)
Change in net funds from cash flows		(530)	(180)	26
Revaluation of Exchange Property	4,5	(248)	–	–
Other non-cash movements		49	21	(1)
Net (decrease)/increase in net funds		(729)	(159)	25
Net funds at start of period		(801)	(826)	(826)
Net funds at end of period	4	(1,530)	(985)	(801)
Reconciliation to movement in net debt as defined by the group				
Net (decrease)/increase in net funds		(729)	(159)	25
Decrease in cash on customers' account	4	9	23	43
Net movement for the period		(720)	(136)	68

Statement of total recognised gains and losses

	Notes	Six months to 30 June 2002 Unaudited £m	Six months to 30 June 2001 Unaudited £m	Year to 31 December 2001 Audited £m
(Loss)/profit for the period				
Group, excluding joint ventures		(33)	(49)	(200)
Joint ventures		(30)	72	66
Total (loss)/profit for the period		(63)	23	(134)
<i>Currency translation on foreign currency net investments – subsidiaries – joint ventures</i>		(68)	14	61
<i>Goodwill on disposal of Flight Simulation and Training Inc.</i>		27	(3)	(10)
<i>Revaluation of Exchange Property</i>	5	–	18	18
		(248)	–	–
Other recognised gains and losses relating to the period (net)		(289)	29	69
Total recognised gains and losses relating to the period		(352)	52	(65)
Prior year adjustment in respect of the adoption of FRS 19		–	(175)	(175)
Total recognised gains and losses		(352)	(123)	(240)

Reconciliation of movements in shareholders' funds

		Six months to 30 June 2002 Unaudited £m	Six months to 30 June 2001 Unaudited £m	Year to 31 December 2001 Audited £m
(Loss)/profit for the period		(63)	23	(134)
Dividends	3	(123)	(117)	(296)
Issue of shares to the QUEST and exercise of share options		(186)	(94)	(430)
Other recognised gains and losses relating to the period (net)		27	19	22
		(289)	29	69
Net decrease in shareholders' funds		(448)	(46)	(339)
Opening shareholders' funds		6,638	6,977	6,977
Closing shareholders' funds		6,190	6,931	6,638

Notes to the Interim Report

1 Exceptional items

	Six months to 30 June 2002 Unaudited £m	Six months to 30 June 2001 Unaudited £m	Year to 31 December 2001 Audited £m
Operating exceptional items			
Prior year rationalisation programmes	(8)	(44)	(95)
B Ae/MES integration costs	(1)	(21)	(53)
	(9)	(65)	(148)
Non-operating exceptional item			
Cessation/reorganisation of commercial aerospace activities	(30)	–	(370)
Exceptional loss included within profit before interest and tax			
	(39)	(65)	(518)

Prior year rationalisation programmes

Rationalisation programmes were initiated in 1999 and 2000 in response to capacity excesses across a number of business groups.

The total costs associated with these programmes were estimated at the time of the respective announcements at £475m. To date costs of £457m have been recorded as exceptional charges. The profit and loss impact in the first half of 2002 has been a charge of £8m, before a tax credit of £2m. A net cash outflow of £10m arose in the first half of 2002 in respect of these costs, before taking into account the cash benefits of tax relief.

B Ae/MES integration costs

Costs associated with the integration of the former British Aerospace and MES businesses totalling £1m were incurred in the first half of 2002, matched by a net cash outflow of £1m, before taking into account the cash benefits of tax relief.

Cessation/reorganisation of commercial aerospace activities

In 2001 the group decided to close its regional jet manufacturing operations and reorganise certain other commercial aerospace activities at a cost of £400m. The profit and loss impact in 2001 was £370m, before a tax credit of £111m. The remaining £30m, before a tax credit of £9m, has been charged in the first half of 2002. The cash outflow in the first half of 2002 in respect of these costs was £106m.

2 Joint venture goodwill amortisation

Included in the £91m amortisation charge is a £44m impairment in respect of the group's interest in Astrium NV.

3 Dividends

The directors have declared the payment of an interim dividend of 3.7p per ordinary share (2001 3.5p). The dividend will be paid on 29 November 2002 to shareholders registered on 18 October 2002. The ex-dividend date will be 16 October 2002.

4 Net debt

Net debt includes a non-cash movement of £248m related to the revaluation of the Exchange Property. This is explained further in note 5.

Net debt disclosed on page 1 at £1,551m (2001 £1,035m) excludes cash received on customers' account of £21m (2001 £50m) which is included within creditors in the consolidated balance sheet. Net funds as disclosed under FRS1 in the cash flow statement on page 10 includes these amounts received on customers' account.

5 Revaluation of Exchange Property

The company has in issue £676m (2001 £676m) 3.75% Senior Unsecured Exchangeable Bonds, due in 2006 (the Bonds). At any time prior to the due date the Bondholders have the right to exchange the Bonds for the Exchange Property, which is represented by the group's holding in the ordinary share capital of Vodafone Group Plc. The Exchange Property has been recorded within current asset investments.

The value of the Exchange Property was initially based on the issue price of the Bonds which represented the realisable value to the group. The historical cost of the Exchange Property to the group is negligible, and the uplift to match the Exchange Property to the value of the Bonds was recorded as an unrealised gain within other reserves.

At 30 June 2002 the value of the group's holding in Vodafone Group Plc was less than the redemption value of the Bonds. Accordingly the group has written down the value of the Exchange Property to its market value at that date. This reduction of £248m in the carrying value has been charged against the original revaluation within other reserves and is disclosed as a non-cash movement in the consolidated cash flow statement.

6 Commercial aircraft financing

	30 June 2002 (unaudited)		
	FRIP aircraft £m	Post-FRIP aircraft £m	Total £m
Future cash flow payments in respect of aircraft financing obligations	2,861	360	3,221
Amounts pre-financed (see below)	(762)	–	(762)
	2,099	360	2,459
Income guaranteed through insurance	(1,467)	–	(1,467)
Anticipated residual values	–	(360)	(360)
Adjustment to net present value	(104)	–	(104)
Exposure at net present value (31 December 2001 £542m)	528	–	528
Amounts included within:			
Creditors	279	–	279
Provisions	249	–	249
	528	–	528

The group provides guarantees in respect of residual values or head lease and finance payments in respect of certain commercial aircraft sold. At 30 June 2002 the group's future cash flow payments in respect of these arrangements was £3,221m (31 December 2001 £3,379m). As part of a restructuring of its gross obligations through the issue of a limited recourse bond in 2001, the group pre-financed the residual value guarantees. The future cash flows associated with this pre-financing totalled £762m at 30 June 2002. A significant proportion of the net exposure of £2,459m is covered by a Financial Risk Insurance Programme (FRIP) which provides insurance cover in respect of potential shortfalls in contracted and expected income. Any anticipated liability in respect of uninsured amounts is accounted for on a net present value basis.

Since the inception of the FRIP, the group has sold further aircraft with residual value guarantees totalling £360m. The directors consider that the group's exposure to these guarantees is covered by the residual values of the related aircraft.

The group is also exposed to actual and contingent liabilities arising from commercial aircraft financing and residual value guarantees given by its joint venture partners, Saab AB and Airbus SAS. Provision is made against the expected net exposures on a net present value basis. The group's exposure is limited to its respective shareholding in each of these joint ventures.

7 Business group analysis

The business group analysis of results for the six months ended 30 June 2002 set out on page 4 forms a part of these notes to the Interim Report. The group has realigned its organisational structure resulting in changes in management responsibility for certain business units. The principal areas of change involve businesses previously managed as part of the former Operations business group. Under the new structure, Marine shipbuilding and Underwater Weapons activities now report as part of the Programmes business group and the Aerostructures activities now report within the Commercial Aerospace business group. RO Defence, being the balance of the former Operations business group, is reported within HQ and other businesses. The business group analysis for 2001 has been restated in line with these changes. However, had the realignment of the organisational structure not taken place, the business group analysis would have been as follows:

	Six months to 30 June 2002 Unaudited		Six months to 30 June 2001 Unaudited	
	Sales £m	Profit/(loss) ¹ £m	Sales £m	Profit/(loss) ¹ £m
Programmes	782	57	1,049	34
Customer Solutions & Support	1,065	220	1,023	190
International Partnerships	658	2	799	51
Avionics	459	4	433	37
North America	1,327	115	1,264	112
Operations	443	(44)	656	13
Commercial Aerospace	1,360	124	1,509	117
Centre	12	(17)	16	(3)
	6,106	461	6,749	551
Less: intra-group	(403)		(457)	
	5,703	461	6,292	551

¹ before interest, goodwill amortisation and exceptional items

8 Pensions

The Accounting Standards Board has proposed to defer the full implementation of FRS 17. As at 30 June 2002, the valuation basis that would be used shows an increase in the FRS 17 pension deficit to £1,300m after taking assumed deferred taxation into account.

However, the group's pension funding requirements are derived from separate independent actuarial valuations which are currently being produced. At this stage these indicate no additional cash funding requirements for 2002, £30m for 2003 and £60m per annum thereafter.

9 Other information

The comparative figures for the year ended 31 December 2001 and other financial information contained in these interim results do not constitute statutory accounts of the group within the meaning of section 240 of the Companies Act 1985.

Statutory accounts for the year ended 31 December 2001 have been delivered to the Registrar of Companies. The auditors have reported on those accounts, their report was not qualified and did not contain a statement under section 237(2) or (3) of the Companies Act 1985. The accounting policies adopted in the preparation of the results to 30 June 2002 are consistent with those set out in the 2001 Annual Report.

This report is being sent to shareholders. Copies are also available to the public from the company's registered office.

Independent review report by KPMG Audit Plc to BAE SYSTEMS plc

Introduction

We have been instructed by the company to review the financial information set out on pages 8 to 13 and we have read the other information contained in the Interim Report and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

Directors' responsibilities

The Interim Report, including the financial information contained therein, is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the Interim Report in accordance with the Listing Rules of the Financial Services Authority which require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual accounts except where they are to be changed in the next annual accounts in which case any changes, and the reasons for them, are to be disclosed.

Review work performed

We conducted our review in accordance with guidance contained in Bulletin 1999/4: *Review of interim financial information* issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of BAE SYSTEMS plc management and applying analytical procedures to the financial information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review is substantially less in scope than an audit performed in accordance with Auditing Standards and therefore provides a lower level of assurance than an audit. Accordingly we do not express an audit opinion on the financial information.

Review conclusion

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the six months ended 30 June 2002.

KPMG Audit Plc
Chartered Accountants
London
11 September 2002

Shareholder information

The Annual General Meeting of BAE SYSTEMS plc for 2003 will be held on 29 April 2003.

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