

BAE Systems Global Combat Systems Munitions Limited

Annual report and financial statements

31 December 2016

Registered number: 01842252



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Strategic report

Principal activities

The principal activity of the Company is the design, development, manufacture and supply of a wide range of defence systems, sub-systems and components.

Review of business

BAE Systems Global Combat Systems Munitions Limited is a wholly owned subsidiary of BAE Systems (Holdings) Limited. The main activity of the Company is the supply of small, medium and large calibre munitions to the UK Ministry of Defence (MoD).

The Company has a strong order book which includes a 15 year contract with UK MoD for the delivery of munitions capability and the supply of a range of munitions. This contract was awarded in 2008 with an initial value of £2 billion.

Principal risks and uncertainties

UK Public Sector Spending

The 2015 UK Strategic Defence and Security Review provided additional clarity regarding future Army programmes and we believe that our advanced planning work and the long term munitions supply contract with the UK MoD will generate revenues that remain in line with the overall business plan.

Delivery Risk

The products that we supply are highly regulated and require ongoing upgrade to ensure the latest legislation is adhered to provide safe operation. This requires careful management to, particularly within engineering minimise the inherent risks in that aspect of our work.

Key performance indicators

The Company is part of the BAE Systems plc Group and the key performance indicators used to monitor and review the business are set by the Group and discussed in more detail in the annual report of the Group.

The following additional key performance indicators at a company level are used to monitor and review the development, performance or position of the business:

Key financial performance indicators are shown below:

	2016	2015
	£m	£m
Order intake	43	17
Revenue	212	196
Operating profit	22	24

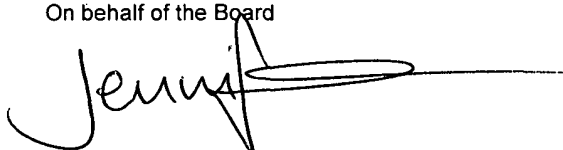
Order intake represents the value of funded orders received from customers in the year. It is a measure of in-year performance and supports future years' sales performance. The increase in orders in 2016 is driven by increased volumes across the portfolio.

We continue to have a strong order book which includes a 15 year contract with UK MoD for the delivery of munitions.

Revenue represents the amounts derived from the provision of goods and services. The increase in revenue is due to higher deliveries across the portfolio.

Operating profit is used for internal performance analysis as a measure of operating profitability that is comparable over time and is broadly in line with 2015.

On behalf of the Board



J B Osbaldestin
Director
15 June 2017

Directors' report

Company registration

BAE Systems Global Combat Systems Munitions Limited is a private company, limited by shares and registered in England and Wales with the registered number 01842252.

Results and dividends

The Company's profit for the financial year is £18m (2015: £25m). The directors do not propose a dividend for 2016 (2015: £nil).

Looking forward

The Company's outlook is linked to the UK Government's defence requirements and the contract with the UK MoD. There have been recent cost and volume pressures in relation to this contract and the Company is working closely with this major customer throughout this challenging time. This is a 15 year contract, awarded in 2008. The Company has pushed hard to secure export orders and has recently achieved contracts with the Royal Oman Army, New Zealand Defence Force and the French Army. The Company expects to expand its export orders in the future.

Going concern

After making due enquiries, the directors have a reasonable expectation that the Company has adequate resources to continue operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Employees

The diversity, skills and innovation of our people drives performance across the Company.

The Company is committed to creating a diverse and inclusive work environment where a diverse range of talented people can work together to ensure business delivery. We are creating this environment by striving to build a diverse workforce from entry level to senior management which reflects the populations that we recruit from.

Engaging and developing our workforce for current and future business is key to successfully delivering our strategy and customer commitments. We are continuously looking to attract, recruit, develop and reward people of the highest calibre.

We want every employee to fulfil their potential while contributing to the success of the Company. We do this through our career frameworks, comprehensive development programmes and the breadth of our operations around the UK that enable employees to make the most of their talents. Our focus is on continuous professional development that supports personal and professional growth.

The Company has a number of programmes in place to improve diversity and inclusion across the business, including Executive Committee sponsored work streams to foster a culture of inclusion, accelerate the development of high-potential women and increase leadership diversity. This is underpinned by activities across the Company to improve diversity and inclusion locally.

To support our operations and the industry sectors, the Company partners with the education system in the UK to ensure the future workforce has the core skills and capabilities to develop careers and support industrial strategies. We place particular emphasis on encouraging young people to pursue careers in Science, Technology, Engineering and Mathematics (STEM).

The safety of employees, and anybody who works on, or visits, the Company's sites, remains a priority for the Company. During 2016, the Company continued to focus on raising awareness of employees' role in identifying, managing and reducing safety risks. Throughout the year, employees were encouraged to review work processes to design out potential accidents and suggest improvements to drive standards of safety across the Company.

The Company is committed to creating environments that enable employees to contribute to improving business performance through our engagement activities, including regular feedback to support their success, and drive responsible behaviour and safe working practices. The Company seeks to listen to employees' views and opinions, and keep them informed about what is happening across the business through a variety of media, including e-enabled channels, leadership blogs, newsletters, management and team meetings, monthly team briefs, and the intranet. Employees also have the opportunity to provide feedback via engagement surveys.

The Company welcomes employees becoming shareholders in BAE Systems plc and offers a number of employee share plans to support this.

Directors' report (*continued*)

Research and Development (R&D)

The Company is focused on technology innovation and engineering excellence and invests in next-generation research and technology programmes to improve the manufacturing and service of products, generating substantial intellectual property. Total research and development expenditure in the year was £2.2m (2015: £1.6m), of which £0.6m (2015: £1.3m) was funded by the Company.

Financial instruments

The global nature of the Company's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Company's policy is to hedge all material firm transactional exposures.

Directors and their interests

The directors who served during the year and at the date of this report were as follows:

M S Miller

J B Osbaldestin (appointed 24 February 2016)

D J Clapham (resigned 1 April 2016)

The Board is not aware of any contract of significance in relation to the Company in which any director has, or has had, a material interest.

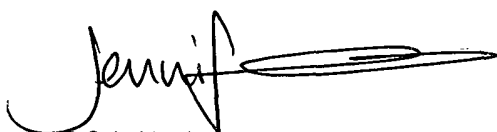
Disclosure of information to auditor

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is *no relevant audit information of which the Company's auditor is unaware*; and each director has taken all the steps that he/she ought to have taken to make himself/herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

Auditor

The auditor, KPMG LLP, has indicated its willingness to continue in office and in accordance with section 487(2) of the Companies Act 2006, has been reappointed.

On behalf of the Board



J B Osbaldestin
Director

15 June 2017

Registered office:
BAE Systems Global Combat Systems Munitions Limited
Warwick House
PO Box 87
Farnborough Aerospace Centre
Farnborough
Hampshire
GU14 6YU
England
United Kingdom

Statement of directors' responsibilities in respect of the strategic report, directors' report and the financial statements

The directors are responsible for preparing the Strategic Report, the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice), including FRS 101 *Reduced Disclosure Framework*.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

Independent auditor's report to the members of BAE Systems Global Combat Systems Munitions Limited

We have audited the financial statements of BAE Systems Global Combat Systems Munitions Limited for the year ended 31 December 2016 set out on pages 8 to 32. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice), including FRS 101 *Reduced Disclosure Framework*.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 6, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2016 and of its profit for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year is consistent with the financial statements.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic Report and Directors' Report:

- we have not identified material misstatements in those reports; and
- in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.


Richard Evans (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants
KPMG LLP
Edward VII Quay
Navigation Way
Preston
PR2 2YF

20 June 2017

Income statement

for the year ended 31 December 2016

	Notes	2016 £m	2015 £m
Revenue	2	212	196
Operating costs	3	(194)	(175)
Other income	4	4	3
Operating profit		22	24
Income from subsidiary undertakings and participating interests	5	-	-
Profit before finance costs and taxation		22	24
Financial income	6	1	2
Financial expense	7	(6)	(1)
Profit before taxation		17	25
Taxation income/ (expense)	9	1	-
Profit for the year		18	25

Statement of comprehensive income

for the year ended 31 December 2016

	2016 £m	2015 £m
Profit for the year	18	25
Other comprehensive(expense)/ income		
Items that will not be reclassified to the income statement:		
Remeasurements on retirement benefit schemes	(12)	37
Tax on items that will not be reclassified to the income statement	2	(7)
Items that may be reclassified to the income statement:		
Amounts credited to hedging reserve	2	-
Tax on items that may be reclassified to the income statement	-	-
Total other comprehensive(expense)/ income for the year (net of tax)	(8)	30
Total comprehensive income for the year	10	55

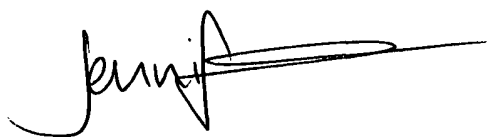
The notes on pages 11 to 32 form part of the financial statements.

The results for 2016 and 2015 arise from continuing activities.

Balance sheet
as at 31 December 2016

	Notes	2016 £m	2015 £m
Non-current assets			
Property, plant and equipment	10	108	117
Other investments	11	-	-
Retirement benefit surpluses	17	86	77
		194	194
Current assets			
Inventories	14	30	27
Trade and other receivables including amounts due from customers for contract work	15	161	130
Other financial assets	12	2	1
		193	158
Total assets		387	352
Non-current liabilities			
Retirement benefit obligations	17	(69)	(51)
Other financial liabilities	12	-	(1)
Deferred tax liabilities	13	(8)	(11)
Provisions	18	(6)	(3)
		(83)	(66)
Current liabilities			
Trade and other payables	16	(268)	(261)
Other financial liabilities	12	(2)	(2)
Provisions	18	(6)	(6)
		(276)	(269)
Total liabilities		(359)	(335)
Net assets		28	17
Capital and reserves			
Issued share capital	19	50	50
Other reserves	19	-	(2)
Retained deficit		(22)	(31)
Total equity		28	17

Approved by the Board on 15 June 2017 and signed on its behalf by:



J B Osbaldestin
Director

Registered number: 01842252

Statement of changes in equity
for the year ended 31 December 2016

	Notes	Issued share capital £m	Other reserves £m	Retained earnings £m	Total equity £m
At 1 January 2015		50	(2)	(86)	(38)
Profit for the year		-	-	25	25
Total other comprehensive income for the year		-	-	30	30
Share-based payments	20	-	-	-	-
At 31 December 2015		50	(2)	(31)	17
Profit for the year		-	-	18	18
Total other comprehensive income for the year		-	2	(10)	(8)
Share-based payments	20	-	-	1	1
At 31 December 2016		50	-	(22)	28

Notes to the financial statements

1 Accounting policies

Basis of preparation

These financial statements were prepared in accordance with Financial Reporting Standard (FRS) 101 Reduced Disclosure Framework. Amendments to FRS 101 (2014/15 cycle and other minor amendments) and Amendments to FRS 101 (2015/16 cycle), both effective for periods beginning on or after 1 January 2016, have been applied.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (IFRS) as adopted by the EU (EU-adopted IFRS), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken:

- the requirements of paragraphs 45(b) and 46 to 52 of IFRS 2, Share-based Payment;
- the requirements of IFRS 7, Financial Instruments: Disclosures;
- the requirements of paragraphs 91 to 99 of IFRS 13, Fair Value Measurement;
- the requirement in paragraph 38 of IAS 1, Presentation of Financial Statements, to present comparative information in respect of: paragraph 79(a)(iv) of IAS 1; paragraph 73(e) of IAS 16, Property, Plant and Equipment;
- the requirements of paragraphs 10(d), 10(f), 16, 38A, 38B, 38C, 38D, 40A, 40B, 40C, 40D, 111 and 134 to 136 of IAS 1, Presentation of Financial Statements;
- the requirements of IAS 7, Statement of Cash Flows;
- the requirements of paragraphs 17 and 18A of IAS 24, Related Party Disclosures; and
- the requirements in IAS 24, Related Party Disclosures, to disclose related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

The Company is exempt under section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it and its subsidiary undertakings are included by full consolidation in the consolidated financial statements of its ultimate parent, BAE Systems plc, a company registered in England and Wales. Accordingly, these financial statements present information about the Company as an individual undertaking and not as a group.

The following paragraphs summarise the main accounting policies of the Company and have, unless otherwise stated, been applied consistently to all periods presented in these financial statements.

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of relevant financial assets and financial liabilities (including derivative instruments). The going concern basis has been applied in these accounts.

Notes to the financial statements *(continued)*

1 Accounting policies *(continued)*

Going Concern

The Company's principal business activities together with the factors likely to affect its future development, performance and position are set out in the Strategic Report on page 3. Notes to the financial statements include details of the Company's exposures to credit risk, liquidity risk and interest rate risk.

The Company continues to generate sufficient income. As a consequence, the directors believe that the Company is well placed to manage its business risks successfully despite the current uncertain economic outlook.

The directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Revenue and profit recognition

Revenue represents income derived from the provision of goods and services by the Company.

Long-term contracts

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

Where services are performed over more than one period then revenue is recognised when each separately identifiable phase (milestone) of the contract has been completed.

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. No profit is recognised until the outcome of a contract can be reliably estimated. Profit is recognised progressively as risks have been mitigated or retired.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods supplied and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

Revenue and profits on intercompany trading are determined on an arm's length basis.

Leases

Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

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

Research and development

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

Company-funded expenditure on research, and on development activities not meeting the conditions for capitalisation, is written off as incurred and charged to the income statement.

Customer-funded expenditure on research and development activities is held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Company's revenue recognition policy.

Interest income and borrowing costs

Interest income and borrowing costs are recognised in the income statement in the period in which they are incurred.

Dividends

Dividends received and receivable are credited to the Company's income statement. Equity dividends paid on ordinary share capital are recognised as a liability in the period in which they are declared.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rate ruling at the date of the transaction. 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 income statement.

Notes to the financial statements *(continued)*

1 Accounting policies *(continued)*

Property, plant and equipment

Cost

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. The cost of demonstration assets is written off as incurred.

Depreciation

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
Computing equipment and motor vehicles	- 4 to 5 years
Other equipment	- 10 to 20 years, or the project life if shorter

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

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date.

Impairment

The carrying amounts of the Company's property, plant and equipment are reviewed, at each balance sheet date to determine whether there is any indication of impairment.

Other investments

Fixed asset investments in shares in subsidiary undertakings and in shares in participating interests are stated at cost less provision for impairment.

The carrying amounts of the Company's investments are reviewed annually to determine whether there is any indication of impairment as required by IAS 36, Impairment of Assets. An impairment loss is recognised whenever the carrying amount of an investment exceeds its recoverable amount.

Impairment losses are recognised in the income statement. 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 if no impairment loss had been recognised.

Inventories

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

Trade and other receivables

Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt is established when there is objective evidence that the Company 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. Receivables with a short-term duration are not discounted.

A loss on provision for bad debt is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. 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 long-term contract balances for that portion of the work which has already been completed, and the remainder is included as amounts due to long-term contract customers within trade and other payables. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

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.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term 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.

Notes to the financial statements *(continued)*

1 Accounting policies *(continued)*

Trade and other payables

Trade and other payables are stated at their cost.

Tax

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

Current tax

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

Deferred tax

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

- on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;
- related to investments in subsidiaries and equity accounted investments to the extent that it is possible that they will not reverse in the foreseeable future; and
- arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority and they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

Provisions

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

Legal, contractual and environmental

The Company holds provisions for expected legal, contractual and environmental 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.

Notes to the financial statements (continued)

1 Accounting policies (continued)

Retirement benefit obligations

Defined contribution pension schemes

A defined contribution pension scheme is a post-employment benefit plan under which the Company pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts.

Obligations for contributions are recognised as an expense in the income statement as incurred.

Defined benefit pension schemes

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. Remeasurements, including actuarial gains and losses, are recognised in the Statement of comprehensive income in the period in which they occur. Past service costs resulting from a plan amendment or curtailment are recognised immediately in the income statement.

The retirement benefit surpluses and obligations recognised in the Company's balance sheet represents the fair value of scheme assets, less the present value of the defined benefit obligations calculated using a number of actuarial assumptions as set out on page 26. The bid values of scheme assets are not intended to be realised in the short term and may be subject to significant change before they are realised. The present values of scheme liabilities are derived from cash flow projections over long periods and are, therefore, inherently uncertain.

IAS 19, Employee Benefits, limits the measurement of a defined benefit surplus to the lower of the surplus in the defined benefit scheme and the asset ceiling. The asset ceiling is the present value of any economic benefits available in the form of refunds from the scheme or reductions in future contributions to the scheme. IFRIC 14, IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, issued in 2007, provides an interpretation of the requirements of IAS 19, clarifying that a refund is available if the entity has an unconditional right to a refund in certain circumstances. The Group has applied IFRIC 14 and has determined that there is no limit on the recognition of the surpluses in its defined benefit pension schemes as at 31 December 2016.

The Company participates in a number of group and multi-employer schemes administered by its ultimate parent company, BAE Systems plc. A share of the IAS 19, Employee Benefits, pension deficit has been allocated to all participating employers. This allocation is based on the relative payroll contributions of active members which is consistent with prior years. Whilst this methodology is intended to reflect a reasonable estimate of the share of the deficit, it may not accurately reflect the obligations of the participating employers.

In the event that an employer who participates in BAE Systems plc's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Company considers the likelihood of this event arising as remote.

Share-based payments

BAE Systems plc issues equity-settled share options to employees of the Company. In accordance with the requirements of IFRS 2, Share-based Payment, the Company has recognised a charge for the equity-settled share options issued to its employees.

Equity-settled share options and long-term incentive plan arrangements are measured at fair value at the date of grant using an option pricing model.

The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of the number of shares that will actually vest.

Financial instruments

Cash flow hedges

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 in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction 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.

Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

Notes to the financial statements (continued)

2 Segmental analysis

Revenue by customer location	2016 £m	2015 £m
United Kingdom	188	166
Rest of Europe	16	21
Middle East	-	3
USA and Canada	7	5
Asia and Pacific	1	1
	212	196

Revenue by category	2016 £m	2015 £m
Long-term contracts	114	108
Sale of goods	98	88
	212	196

3 Operating costs

	2016 £m	2015 £m
Raw materials, subcontracts and other bought-in items	57	62
Change in inventories of finished goods and work in progress	3	(11)
Cost of inventories expensed	60	51
Staff costs (note 8)	53	52
Depreciation, amortisation and impairment	13	13
Other operating charges	68	59
Operating costs	194	175
Included within the above analysis are the following expenses:		
Lease and sublease expense	11	10

The remuneration of the auditor for the year ended 31 December 2016 for statutory audit work was £0.2m (2015 £0.2m).

Total research and development expenditure was £2.2m (2015 £1.6m), of which £0.6m (2015 £1.3m) was funded by the Company.

4 Other income

	2016 £m	2015 £m
Sale of scrap	1	1
Salary recharges	1	1
Other	2	1
Other income	4	3

5 Income from subsidiary undertakings and participating interests

During the year the Company received a dividend from International Military Sales Limited for £144,000 (2015 £197,000)

Notes to the financial statements *(continued)*

6 Financial income

	2016 £m	2015 £m
Foreign exchange gains	-	2
Net interest expense on retirement benefit obligations (note 17)	1	-
Financial income	1	2

7 Financial expense

	2016 £m	2015 £m
Foreign exchange losses	5	-
Interest payable on intra group loans	1	1
Financial expense	6	1

8 Employees

The average number of Company employees was as follows:

	2016	2015
	1,130	1,149

The aggregate staff costs of Company employees were as follows:

	2016 £m	2015 £m
Wages and salaries	40	39
Social security costs	4	4
Pension costs – defined contribution plans (note 17)	1	1
Pension costs – defined benefit plans (note 17)	7	8
Share-based payments (note 20)	1	-
	53	52

Notes to the financial statements (continued)

8 Employees (continued)

Directors' remuneration

The disclosures below represent an allocation of the emoluments received by the directors to reflect their qualifying services to the Company.

	2016 £'000	2015 £'000
Directors' remuneration	235	316
Amounts receivable under long-term incentive schemes	21	5
Company contributions to defined benefit pension schemes	40	54
Compensation for loss of office	139	-
	435	375

Retirement benefits are accruing to the following number of directors under:

	2016 Number of directors	2015 Number of directors
Defined benefit schemes	3	4

	2016 Number of directors	2015 Number of directors
The number of directors who exercised share options was	-	1
The number of directors in respect of whose qualifying services shares were received or receivable under long-term incentive schemes was	2	1

Amounts paid in respect of the highest paid director were as follows:

	2016 £'000	2015 £'000
Remuneration and amounts receivable under long-term incentive schemes	171	155
Company contributions to defined benefit pension schemes	4	30
	175	185

The highest paid director's defined benefit accrued pension and accrued lump sum at 31 December 2016 was £29k (2015: £125k) and £nil (2015: £nil), respectively.

Notes to the financial statements (continued)

9 Taxation expense

The Company has not provided for corporation tax for the year as any profits will be covered by the surrender of losses from other Group undertakings, in respect of which no payment will be made.

Taxation expense	2016 £m	2015 £m
Current taxation		
UK: Current tax (charge) for the year	-	-
	-	-
Deferred taxation		
Origination and reversal of temporary differences	1	3
Adjustments in respect of prior years	-	(4)
Tax rate adjustment	-	1
Taxation income/ (expense)	1	-

Reconciliation of taxation expense

The following reconciles the expected tax (expense), using the UK corporation tax rate, to the reported tax income.

	2016 £m	2015 £m
Profit before taxation	17	25
UK corporation tax rate	20.00%	20.25%
Expected tax (expense) on profit	(3)	(5)
Accelerated capital allowances	(1)	-
Pensions & other provisions	1	-
Losses received from group companies	4	5
Taxation income/ (expense)	1	-

Tax recognised in other comprehensive income

	2016			2015		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
Items that will not be reclassified to the income statement:						
Remeasurements on retirement benefit schemes	12	(2)	10	37	(7)	(30)
Items that may be reclassified to the income statement:						
Amounts (charged)/credited to hedging reserve	(2)	-	(2)	-	-	-
	10	(2)	8	37	(7)	(30)

	2016			2015		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Deferred tax						
Pensions	-	(2)	(2)	-	(7)	(7)
	-	(2)	(2)	-	(7)	(7)
Tax on other comprehensive income	-	(2)	(2)	-	(7)	(7)

The UK Corporation tax rate was reduced from 20% to 19% with effect from 1 April 2017, and will be reduced to 17% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from the prior year enacted tax rate of 18% to 17%, creating a rate adjustment in 2016, which is partly reflected in the income statement and partly reflected in the statement of comprehensive income.

Notes to the financial statements (continued)

10 Property, plant and equipment

	Land and Buildings £m	Plant and machinery £m	Total £m
Cost or valuation			
At 1 January 2016	36	164	200
Additions	-	4	4
Disposals	-	(5)	(5)
At 31 December 2016	36	163	199
Depreciation and impairment			
At 1 January 2016	8	75	83
Depreciation charge for the year	1	12	13
Disposals	-	(5)	(5)
At 31 December 2016	9	82	91
Net book value			
At 31 December 2016	27	81	108
At 31 December 2015	28	89	117
Non-depreciated assets:			
Assets in the course of construction	1	12	13
	1	12	13

Capital commitments

Capital expenditure contracted for but not provided for in full in the accounts is £2.4m (2015 £1.7m).

Operating lease commitments

The Company leases various offices and factories under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

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

	2016 £m	2015 £m
Payments due:		
Not later than one year	11	11
Later than one year and not later than five years	43	42
Later than five years	123	134
	177	187

Notes to the financial statements (continued)

11 Other investments

Carrying value £m

At 1 January 2016 and 31 December 2016 -

Subsidiary undertakings and participating interests at 31 December 2016

In accordance with Section 409 of the Companies Act 2006, a full list of subsidiary undertakings and significant holdings as at 31 December 2016 is disclosed below. Unless otherwise stated, all subsidiary undertakings and significant holdings are owned directly by the Company, have a financial year end of 31 December and the address of the registered office is Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire GU14 6YU, United Kingdom.

Company name	Class of shares held	Proportion of class (%)
Royal Ordnance (Crown Service) Pension Scheme Trustees Limited	Ordinary £1 shares	100
Royal Ordnance Senior Staff Pension Scheme Trustees Limited	Ordinary £1 shares	100
International Military Sales Limited	Ordinary £1 shares	100

12 Other financial assets and liabilities

	2016		2015	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	-	-	-	(1)
Current				
Cash flow hedges – foreign exchange contracts	2	(2)	1	(2)

Contracted cash flows

The net contractual cash flows on derivative financial instruments at the reporting date are £nil (2015: £nil).

Notes to the financial statements (continued)

13 Deferred tax

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2016 £m	2015 £m	2016 £m	2015 £m	2016 £m	2015 £m
Property, plant and equipment	-	-	(7)	(7)	(7)	(7)
Provisions and accruals	2	1	-	-	2	1
Pension/retirement schemes: surplus	-	-	(3)	(5)	(3)	(5)
Net deferred tax assets/(liabilities)	2	1	(10)	(12)	(8)	(11)

Movement in temporary differences during the year

	At 1 January 2016 £m	Recognised In income £m	Recognised In equity £m	At 31 December 2016 £m
Property, plant and equipment	(7)	-	-	(7)
Provisions and accruals	1	1	-	2
Pension schemes: surplus	(5)	-	2	(3)
	(11)	1	2	(8)

	At 1 January 2015 £m	Recognised In income £m	Recognised In equity £m	At 31 December 2015 £m
Property, plant and equipment	(8)	1	-	(7)
Provisions and accruals	2	(1)	-	1
Pension schemes: deficit/(surplus)	2	-	(7)	(5)
	(4)	-	(7)	(11)

Future changes in rates

The UK Corporation tax rate was reduced from 20% to 19% with effect from 1 April 2017, and will be reduced to 17% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from the prior year enacted tax rate of 18% to 17%, creating a rate adjustment in 2016, which is partly reflected in the income statement and partly reflected in the statement of comprehensive income.

Notes to the financial statements (continued)

14 Inventories

	2016 £m	2015 £m
Raw materials and consumables	15	21
Finished goods and goods for resale	15	6
	30	27

15 Trade and other receivables

	2016 £m	2015 £m
Current		
Long-term contract balances	31	38
Less: attributable progress payments	(1)	(2)
Amounts due from customers for contract work	30	36
Trade receivables	24	16
Amounts owed by group companies	102	72
Other receivables	5	6
	161	130

16 Trade and other payables

	2016 £m	2015 £m
Current		
Trade payables	8	8
Amounts due to long-term contract customers	130	126
Amounts owed to group companies	88	80
Other taxes and social security costs	24	25
Accruals and deferred income	18	22
	268	261

Included above:

Amounts due to long-term contract customers, including contract losses	130	126
Advances from long-term contract customers	-	-

Notes to the financial statements (continued)

17 Retirement benefit obligations

Background

BAE Systems plc operates pension schemes for qualifying employees in the UK, US and other countries. The principal schemes in the UK are funded defined benefit schemes and the assets are held in separate trustee-administered funds. The two largest funded defined benefit schemes are the BAE Systems Pension Scheme (Main Scheme) and the BAE Systems 2000 Pension Plan (2000 Plan).

At 31 December 2016, the weighted average durations of the UK defined benefit pension obligations were 19 years (2015 18 years).

The Company participates in the following BAE Systems plc schemes: Main Scheme, 2000 Plan, Royal Ordnance Pension Scheme, Royal Ordnance Senior Staff Pension Scheme and Alvis Pension Scheme.

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme and 2000 Plan is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme ¹	32	19	49
2000 Plan ²	14	29	57
Royal Ordnance Pension Scheme ³	18	20	62

1. Source: Main Scheme actuarial valuation report as at 31 March 2014.

2. Source: 2000 Plan actuarial valuation report as at 31 March 2014.

3. Source: Royal Ordnance Pension Scheme actuarial valuation 31 December 2013.

Regulatory framework

The funded UK schemes are registered and subject to the statutory scheme specific-funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and BAE Systems plc.

Benefits

The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The normal retirement age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: www.baesystemspensions.com.

Funding

The majority of the UK defined benefit pension schemes are funded by BAE Systems plc's subsidiaries and equity accounted investments. The individual pension schemes' funding requirements are based on actuarial measurement frameworks set out in their funding policies.

For funding valuation purposes, pension scheme assets are included at market value, whilst the liabilities are determined based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The separate actuarial valuations for funding purposes include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 26. The latest valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2014 and showed a funding deficit of £2.6bn. The total net funding deficit in respect of all of the UK schemes was £2.7bn. Deficit recovery plans agreed with the trustees of the relevant schemes run until 2026.

The next UK triennial funding valuations, as at 31 March 2017, commenced in April 2017 and, in conjunction with the trustees of the schemes and other stakeholders, BAE Systems plc will be looking at various options with a focus on the longer-term view. The results of future triennial valuations and associated funding requirements will be impacted by the future performance of investment markets, and interest and inflation rates.

The total Company contributions made to the defined benefit schemes in the year ended 31 December 2016 were £9m (2015 £10m) in line with the schedule of contributions. In 2017, the Company expects to make contributions at a similar level to the recurring contributions and deficit funding as made in 2016.

The Company incurred a charge of £1m (2015 £1m) in relation to defined contribution schemes for employees.

Notes to the financial statements *(continued)*

17 Retirement benefit obligations *(continued)*

Risk management

The defined benefit pension schemes expose BAE Systems plc to actuarial risks, including market (investment) risk, interest rate risk, inflation risk and longevity risk.

Risk	Mitigation
Market (investment) risk	
Asset returns may not move in line with the liabilities and may be subject to volatility.	<p>The investment portfolios are highly diversified, investing in a wide range of assets, in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities.</p> <p>Some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of market risk.</p>
Interest rate risk	
Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, some of the UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk.
Inflation risk	
Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk.
Longevity risk	
Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	Longevity adjustment factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees.

Notes to the financial statements (continued)

17 Retirement benefit obligations (continued)

Principal actuarial assumptions

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the long-term nature of the obligation covered, may not necessarily occur in practice.

	2016	2015	2014
Financial assumptions			
Discount rate (%)	2.7	3.9	3.6
Inflation (%)	3.2	3.2	3.2
Rate of increase in salaries (%)	3.2	3.2	3.2
Rate of increase in deferred pensions (%)	2.2/3.2	2.3/3.2	2.3/3.2
Rate of increase in pensions in payment (%)	1.7-3.7	1.8 – 3.6	1.8 – 3.6
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	86 – 89	87 – 89	87 – 89
Life expectancy of a female currently aged 65 (years)	89 – 90	89 – 90	89 – 90
Life expectancy of a male currently aged 45 (years)	88 – 91	89 – 91	89 – 91
Life expectancy of a female currently aged 45 (years)	91 – 92	91 – 92	91 – 92

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments of the principal schemes using a third-party AA corporate bond yield curve to produce a single equivalent discount rate. This inherently captures the maturity profile of the expected benefit payments. Further information on the duration of the schemes is detailed on page 24.

Inflation

In the UK, the inflation assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information.

Rate of increase in salaries

The rate of increase in salaries for the UK schemes is assumed to be Retail Prices Index (RPI) inflation of 3.2% (2015 RPI inflation of 3.2%), plus a promotional scale.

Rate of increase in pensions in payment

The rate of increase in pensions in payment differs between UK schemes. Different tranches of the schemes increase at rates based on either RPI or Consumer Prices Index (CPI) inflation, and some are subject to an inflation cap. With the exception of two smaller schemes, the rate of increase in pensions in payment is based on RPI inflation.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on CPI inflation of 2.2% (2015 CPI inflation of 2.3%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.2% (2015 RPI inflation of 3.2%). The rate of increase in deferred pensions is subject to inflation caps.

Life expectancy

The Company has used the Self-Administered Pension Schemes S2 mortality 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 scheme members. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2015 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1.25% (2015 1.25%), for both pensioner and non-pensioner members.

Notes to the financial statements (continued)

17 Retirement benefit obligations (continued)

The disclosures below relate to post-retirement benefit schemes in the UK which are accounted for as defined benefit schemes 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 as updated to take account of the requirements of IAS 19 to assess the deficits of the schemes at 31 December each year. In 2015, the Company presented the total fair value of scheme assets and the total present value of the defined benefit obligations for the schemes in which the Company participated, together with a reconciliation to the Company's share of the net deficit. For 2016, the Company has presented the Company's share of the fair value of scheme assets and the present value of the defined benefit obligations and, therefore, the 2015 disclosures have been re-presented on this basis. This provides more relevant information since only those assets, obligations and associated movements relating to the Company's share of the schemes in which it participates are now presented.

Summary of movements in retirement benefit obligations

	UK £m
Company's share of IAS 19 surplus at 1 January 2016	26
Actual return on assets excluding amounts included in interest income	146
Decrease in liabilities due to changes in assumptions and experience	(158)
Contributions in excess of service cost	2
Net interest income	1
Company's share of IAS 19 surplus at 31 December 2016	17

Amounts recognised on the balance sheet

The table below shows the Company's share of the Group's UK pension schemes after allocation to other participating employers.

	2016 £m	2015 £m
Present value of funded obligations	(1,179)	(1,019)
Fair value of scheme assets	1,196	1,045
Total IAS 19 surplus, net	17	26
Company's share of IAS 19 surplus, net	17	26
Represented by:		
Retirement benefit surpluses	86	77
Retirement benefit obligations	(69)	(51)
	17	26

Notes to the financial statements (continued)

17 Retirement benefit obligations (continued)

Changes in the fair value of scheme assets after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's value of scheme assets at 1 January 2015	1,070
Interest income	38
Actual return on assets excluding amounts included in interest income	(29)
Actual return on assets	9
Contributions by employer	8
Contributions by employer in respect of employee salary sacrifice arrangements	2
Total contributions by employer	10
Members' contributions	-
Benefits paid	(44)
Company's value of scheme assets at 31 December 2015	1,045
Interest income	40
Actual return on assets excluding amounts included in interest income	146
Actual return on assets	186
Contributions by employer	7
Contributions by employer in respect of employee salary sacrifice arrangements	2
Total contributions by employer	9
Members' contributions	-
Benefits paid	(44)
Company's value of scheme assets at 31 December 2016	1,196

Assets of defined benefit pension schemes

	2016			2015 ⁴		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	50	-	50	45	-	45
Overseas	33	-	33	31	-	31
Pooled investment vehicles ¹	8	222	230	6	201	207
Fixed interest securities:						
UK gilts	404	-	404	350	-	350
UK corporates	231	1	232	209	2	211
Overseas government	1	-	1	-	-	-
Overseas corporates	93	3	96	72	3	75
Index-linked securities:						
UK gilts	329	-	329	320	-	320
UK corporates	9	5	14	8	5	13
Property ²	-	49	49	-	48	48
Derivatives ³	-	(265)	(265)	-	(287)	(287)
Cash:						
Sterling	13	-	13	21	-	21
Foreign currency	2	-	2	3	-	3
Other	-	8	8	-	8	8
Company total	1,173	23	1,196	1,065	(20)	1,045

1. Primarily invested in equities. The amounts classified as unquoted primarily comprise investments in private equity, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.

2. Valued on the basis of open market value at the end of the year determined in accordance with the Royal Institution of Chartered Surveyors' Appraisal and Valuation Standards and the Practice Note contained therein.

3. Includes interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.

4. Restated following reinterpretation of the classifications, including the allocation between quoted and unquoted assets.

Notes to the financial statements (continued)

17 Retirement benefit obligations (continued)

Changes in the present value of the defined benefit obligations after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's defined benefit obligations at 1 January 2015	(1,079)
<i>Current service cost</i>	(6)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(2)
Total current service cost	(8)
Members' contributions	-
Past service cost – plan amendments	-
Actuarial (loss)/gain due to changes in assumptions and experience	62
Interest expense	(38)
Benefits paid	44
Company's defined benefit obligations at 31 December 2015	(1,019)
<i>Current service cost</i>	(5)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(2)
Total current service cost	(7)
Members' contributions	-
Past service cost – plan amendments	-
Actuarial (loss)/gain due to changes in assumptions and experience	(158)
Interest expense	(39)
Benefits paid	44
Company's defined benefit obligations at 31 December 2016	1,179

Amounts recognised in the income statement after allocation to other participating employers

	2016 £m	2015 £m
Included in operating costs:		
Current service cost	7	8
	7	8
Included in finance income:		
Net interest income on retirement benefit obligations	1	-

Notes to the financial statements *(continued)*

17 Retirement benefit obligations *(continued)*

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2016 and keeping all other assumptions as set out on page 26.

Financial assumptions

Changes in the following financial assumptions would have the following effect on the defined benefit pension obligation after allocation to other participating employers:

	(Increase)/ decrease in pension obligation £m
Discount rate:	
0.1 percentage point increase	25
0.1 percentage point decrease	(24)
Inflation:	
0.1 percentage point increase	(25)
0.1 percentage point decrease	24

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/ Decrease in pension obligation £m
Inflation:	
0.5 percentage point increase	(87)
0.5 percentage point decrease	80
1.0 percentage point increase	(172)
1.0 percentage point decrease	147

Demographic assumptions

Changes in the life expectancy assumption would have the following effect on the total net IAS 19 deficit after allocation to other participating employers:

	(Increase)/ Decrease in net deficit £m
Life expectancy:	
One-year increase	(33)
One-year decrease	33

Notes to the financial statements (continued)

18 Provisions

	Legal, contractual and environmental £m
Non-current	3
Current	6
At 1 January 2016	9
Created	8
Released	(2)
Utilised	(3)
At 31 December 2016	12
Represented by:	
Non-current	6
Current	6
	12

Legal, contractual and environmental

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

19 Share capital and other reserves

Share capital

	£0.25 Ordinary shares '000	Nominal value £m
Issued and fully paid		
At 1 January and 31 December 2016	200,000	50

Other reserves

	Hedging reserve £m	Total £m
At 1 January 2015 and 31 December 2015	(2)	(2)
Amounts credited to hedging reserve	2	2
At 31 December 2016	-	-

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Notes to the financial statements (continued)

20 Share-based payments

Options over shares of the ultimate parent company, BAE Systems plc, have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Annual Remuneration Report of the BAE Systems plc Annual Report.

For options outstanding at the end of the year:

	2016		2015	
	Range of exercise price of outstanding options (£)	Weighted average remaining contracted life (years)	Range of exercise price of outstanding options (£)	Weighted average remaining contracted life (years)
Executive Share Option Plan	-	-	3.01 - 5.43	8
Performance Share Plan	-	-	-	5
Share Matching Plan	-	-	-	-

The average share price in the year was £5.24 (2015 £4.87), and the Company incurred a charge of £1m (2015: £nil).

21 Contingent liabilities

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

22 Controlling parties

The immediate parent company is BAE Systems (Holdings) Limited and the ultimate parent company is BAE Systems plc. Both companies are incorporated in Great Britain and registered in England and Wales.

The consolidated accounts of BAE Systems plc are available to the public and may be obtained from:

6 Carlton Gardens
London
SW1Y 5AD

Website: www.baesystems.com