

BAE SYSTEMS (Funding Two) Limited

Directors' Report and Financial Statements for the year ended 31 December 2006

Registered Number 4333003



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Directors' report

The Directors present their annual report, together with the audited financial statements, for the year to 31 December 2006

Principal activities and business review

The principal activity of the Company was that of a group investment company

The profit for the year after taxation amounted to \$8,674,000 (2005 \$763,000) The Directors do not recommend the payment of a dividend (2005 Nil)

During the year the company has received early settlement of the outstanding consideration for the share capital originally subscribed to by BAE SYSTEMS Inc. The company has subsequently lent these funds back to BAE SYSTEMS Inc

Principal risks and uncertainties

The principal risk facing the company is the recoverability of the loan to BAE SYSTEMS Holdings Inc. During the year an in depth review of the two key group debtors, BAE SYSTEMS Holdings Inc and BAE SYSTEMS Plc has been undertaken. Based upon the results of this review, the directors believe that the amounts owed are fully recoverable.

Key performance indicators ("KPIs")

Given the straightforward nature of the business, the company's directors are of the opinion that analysis using KPIs is not necessary for an understanding of the development, performance or position of the business. The directors use standard financial measures to monitor the performance of its investments.

Directors

The directors who served during the period and at the date of this report were

Mr D S Parkes	
Mr A L McIlhinney	(appointed 20/11/2006)
Mr M Lester	(resigned 19/12/2006)
Mr C J Glasson	(resigned 20/11/2006)

None of the Directors had any beneficial or non-beneficial interest in the share capital of the Company during the year, nor in the period from 31st December 2006 to the date of this report. 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. The beneficial, including family, interest in the share capital of BAE SYSTEMS plc, the ultimate holding company, of the persons who are Directors at the end of the year are shown below.

Ordinary Shares of 2 5p each of BAE SYSTEMS plc

	Shares	
	At 1st January 2006*	At 31st December 2006
D S Parkes	2,866	4,550
A L McIlhinney	5,453	5,456

	Share Options				
	At 1st January 2006*	Exercised during 2006	Lapsed during 2006	Granted during 2006	At 31st December 2006
Executive share option plan					
D S Parkes	51,000	-	10,000	8,504	49,504
A L McIlhinney	247,590	-	-	-	247,590
SAYE share option scheme					
D S Parkes	3,050	1,133	-	-	1,917
A L McIlhinney	2,888	-	-	-	2,888
Performance share plan					
D S Parkes	15,200	-	-	5,669	20,869
A L McIlhinney	93,024	-	-	-	93,024

* or later date of appointment

Directors' report continued

Auditors

The auditors, KPMG Audit Plc, have indicated their willingness to continue in office and pursuant to a shareholders' resolution, the Company is not obliged to reappoint its auditors annually and KPMG Audit Plc will therefore continue in office

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 auditors are unaware, and each directors has taken all the steps that he ought to have taken to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information

By order of the Board



D S Parkes
Director

Registered Office
Warwick House
PO Box 87
Farnborough Aerospace Centre
Farnborough
Hants GU14 6YU

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

The directors are responsible for preparing 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.

The financial statements are required by law to 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 judgments and estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements, and
- prepare the 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 proper accounting records that disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that its financial statements comply with the Companies Act 1985. 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 auditors' report to the members of BAE SYSTEMS (Funding Two) Limited

We have audited the financial statements of BAE SYSTEMS Funding Two Limited for the year ended 31 December 2006 which comprise the Profit and loss account, the Balance sheet and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. 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 auditors

The directors' responsibilities for preparing the financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the Statement of directors' responsibilities on page 4.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements. In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 2006 and of its profit for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' report is consistent with the financial statements.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants
Registered Auditor
London

15 June 2007

Profit and loss account

		Year ended 31 Dec 2006 \$'000	Year ended 31 Dec 2005 \$'000
Note 3	Interest receivable and similar income	<u>8,674</u>	<u>763</u>
	Profit on ordinary activities before taxation	8,674	763
	Tax on profit on ordinary activities	<u>-</u>	<u>-</u>
	Profit for the financial year	<u>8,674</u>	<u>763</u>

All results arise from continuing operations. The Company had no recognised gains or losses for the year ended 31 December 2006 other than those shown above.

Balance sheet

		As at 31 Dec 2006 \$'000	As at 31 Dec 2005 \$'000
	Current Assets		
Note 4	Debtors amounts due within one year	1,243,696	189,888
Note 4	Debtors amounts due after one year	-	940,104
	Cash at bank and in hand	<u>8,809</u>	<u>57,710</u>
	Net Assets	<u>1,252,505</u>	<u>1,187,702</u>
	Capital and reserves		
Note 5	Called up share capital	1,001,000	1,001,000
Note 7	Non-distributable reserve	241,032	184,903
Note 7	Profit and loss account	<u>10,473</u>	<u>1,799</u>
	Equity shareholders funds	<u>1,252,505</u>	<u>1,187,702</u>

These financial statements were approved by the Board on
signed on its behalf by

15 June 2007

and were



D S Parkes

Director

Notes to the accounts

1 Accounting policies

Basis of preparation

The financial statements have been prepared in accordance with applicable accounting standards and under the historical cost convention, and on a going concern basis. The Company's earning stream is wholly in US Dollars and the Company's functional currency is the US Dollar. The Company has therefore also adopted the US Dollar as its reporting currency.

Cash flow statement

The Company is exempt from the requirement of Financial Reporting Standard No. 1 (revised) to prepare a cash flow statement as it is a wholly owned subsidiary undertaking of BAE SYSTEMS plc, and the cash flows are included within the consolidated cash flow statement of that company.

Related party transactions

The company is exempt from the requirement of Financial Reporting Standard No. 8 to disclose transactions with entities that are part of the group or investees of the group qualifying as related parties, as it is a wholly owned subsidiary undertaking of BAE SYSTEMS plc, whose consolidated financial statements are publicly available.

Taxation

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

2 Directors

Emoluments

None of the Directors received any emoluments from the Company during the year (2005 \$Nil).

3 Interest receivable and similar income

	Year ended 31 Dec 2006	Year ended 31 Dec 2005
	\$'000	\$'000
Interest receivable	8,674	763
	<u>8,674</u>	<u>763</u>

4 Debtors:

	Year ended 31 Dec 2006	Year ended 31 Dec 2005
	\$'000	\$'000
Amounts due within one year		
Amounts owed by group undertakings	1,243,681	189,799
Other Debtors	15	89
	<u>1,243,696</u>	<u>189,888</u>
 Amounts due after one year		
Amounts owed by group undertakings	-	940,104

Following early settlement of the outstanding share subscription, BAE SYSTEMS (Funding Two) Limited has subsequently loaned \$1,000,000,000 to BAE SYSTEMS Holdings Inc. This loan is repayable on 30 June 2007.

Notes to the accounts (continued)**5 Share capital**

	Ordinary shares of \$1 each
Authorised	
At 1 January 2006 and 31 December 2006	<u>1,600,000,000</u>
Issued	
At 1 January 2006 and 31 December 2006	<u>1,001,000,100</u>

On 21 June 2002 the Company made an invitation to BAE SYSTEMS Holdings Inc to make an offer to subscribe for 1,001,000,000 ordinary shares of US \$1 each in the capital of the Company. The total subscription price for the shares was US \$1,275,269,169 payable in eight instalments over a period of five years in accordance with the terms and conditions applying to the offer.

On 20 November 2006 the original subscription agreement was amended to allow for early settlement of the outstanding share subscription. Following receipt of the outstanding \$1,051,232,877, as full and final settlement on 20 November, BAE SYSTEMS Holdings Inc obligations under the share subscription agreement were fully discharged.

6 Taxation

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 companies, in respect of which no payment will be made. Provision for deferred tax is not required.

7 Reserves

	Non-distributable reserve \$'000
At 1 January 2006	184,903
Movement during the year	56,129
At 31 December 2006	<u>241,032</u>

This reserve reflects the accretion of the difference between the nominal value of the shares subscribed for by BAE SYSTEMS Holdings Inc on 24 June 2002 and the total subscription price payable in instalments. This subscription is further described at Note 5.

	Profit and loss account \$'000
At 1 January 2006	1,799
Retained profit for the year	8,674
At 31 December 2006	<u>10,473</u>

8 Ultimate parent company

The Company is a wholly owned subsidiary undertaking of its ultimate parent company, BAE SYSTEMS plc, a company 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

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