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BAE Systems

Annual Review

2005

Annual Review 2005



Delivering real advantage

BAE SYSTEMS

BAE Systems is an international company engaged in the development, delivery and support of advanced defence and aerospace systems in the air, on land, at sea and in space. The Company designs, manufactures and supports military aircraft, surface ships, submarines, combat vehicles, radar, avionics, communications, electronics and guided weapon systems. It is a pioneer in technology with a heritage stretching back hundreds of years. It is at the forefront of innovation, working to develop the next generation of intelligent defence and security systems.

BAE Systems has major operations across five continents and customers in some 130 countries. The Company employs approximately 100,000¹ people and generates annual sales in excess of £15 billion through its wholly-owned and equity accounted investment operations.

¹including share of employees of equity accounted investments

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Results in brief, highlights and outlook

Results in brief

Results from continuing operations	2005	2004 ¹
Sales ²	£15,411m	£13,222m
EBITA ³	£1,182m	£1,016m
Operating profit	£900m	£774m
Underlying earnings per share ⁴	22.5p	17.4p
Basic earnings per share ⁵	18.3p	14.2p
Other results including discontinued operations		
Dividend per share	10.3p	9.5p
Cash inflow from operating activities	£2,099m	£2,350m
Net debt as defined by the Group	£1,277m	£668m
Order book ⁶	£59.8bn	£50.1bn

Highlights

- Delivering US growth strategy
- Global land systems business established
- Programmes business profitability and risk profile improved
- Growth from UK MoD partnered support
- European business portfolio restructuring
- Strong Airbus order intake
- Strong operating cash flow
- Underlying earnings per share⁴ up 29.3% at 22.5p
- Dividend increased 8.4% to 10.3p per share for the year

Outlook

Looking forward to 2006, we anticipate an improved performance from our defence businesses with modest organic growth and a full year contribution from the former United Defense activities. We also anticipate an increased contribution from the commercial aerospace sector.

We expect to translate operating profit into operating cash flow, other than some small utilisation of customer advances. We intend to make one-off cash contributions to the pension schemes in 2006.

Important note

This Annual Review is a summary of the information in the full Annual Report of BAE Systems plc. It does not contain sufficient information to allow a full understanding of the results of the Group and state of affairs of the Company or of the Group, and of their policies and arrangements concerning directors' remuneration.

For further information, the full Annual Report should be consulted. This can be found on the Company's website, www.baesystems.com.

Alternatively, copies are available, free of charge, from:
The Company Secretary
BAE Systems plc
6 Carlton Gardens
London SW1Y 5AD

If in future years you wish to receive the full Annual Report you should write to the Company's registrars, Lloyds TSB Registrars, at the address shown on page 37.

¹ as restated under International Financial Reporting Standards

² including share of equity accounted investments' sales

³ earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

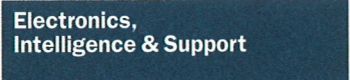


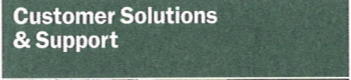
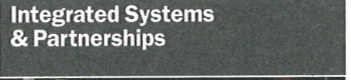
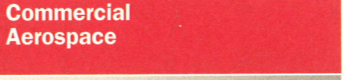
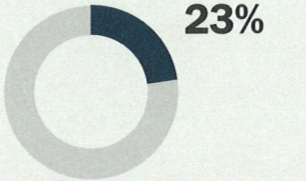
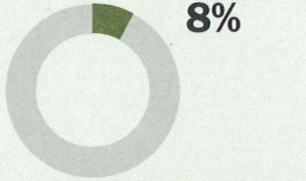
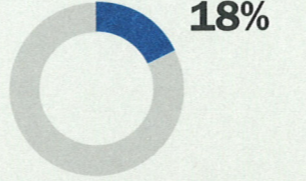



⁴ earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and uplift on acquired inventories

⁵ basic earnings per share in accordance with International Accounting Standard 33

⁶ including share of equity accounted investments' order books and after the elimination of intra-group orders of £0.9bn (2004 £2.6bn)

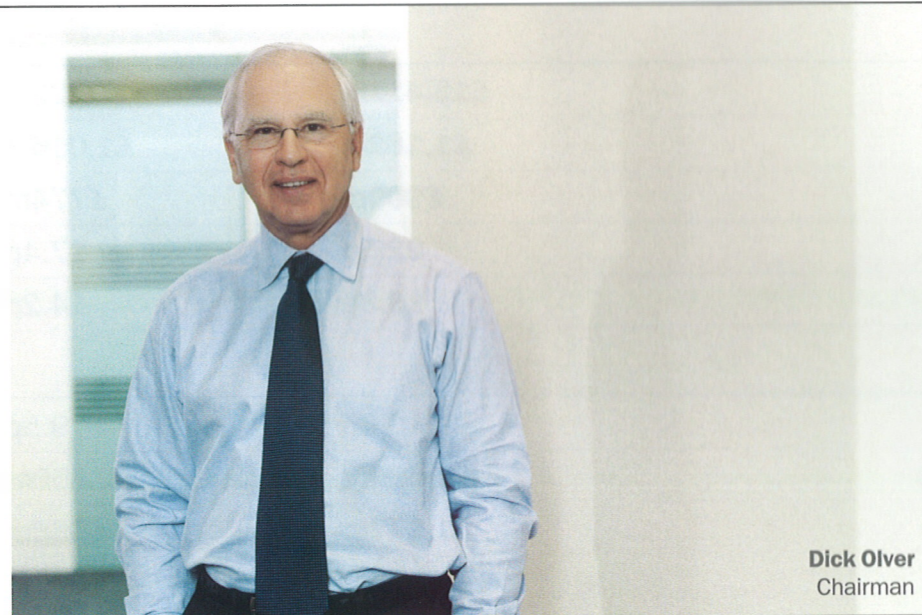
BAE Systems at a glance

BAE Systems is the premier transatlantic defence and aerospace company delivering a full range of products and services for air, land and naval forces as well as advanced electronics, information technology solutions and customer support services.

	 Electronics, Intelligence & Support	 Land & Armaments	 Programmes	 Customer Solutions & Support	 Integrated Systems & Partnerships	 Commercial Aerospace	
Principal operations	An industry leader in a variety of military communications, electronic identification, navigation and guidance systems, and a provider of network centric warfare solutions and a broad range of support solutions, including major ship repair activities for the US Navy.	A global leader in the design, development, production and through-life service support of armoured combat vehicles, major and minor calibre naval guns, missile launchers, canisters, artillery systems and intelligent munitions.	Comprises the Company's air systems, naval ships and submarines activities together with the Company's participation in the UK's Future Carrier programme.	Provides support solutions for current and future customer requirements, addressing the trend within armed forces to work more closely with industry to optimise their military capability in the most effective manner. Key capabilities include the integration and delivery of effective supply chain and logistics management. CS&S is the prime contractor on the Al Yamamah programme.	Comprises a portfolio of high-technology defence systems businesses: Integrated System Technologies; Underwater Systems; 37.5% interest in MBDA; 20.5% interest in Saab; and 50% interest in Gripen International.	Comprises the Company's 20% interest in Airbus together with the Aerostructures business and the regional aircraft asset management and support activities.	Principal operations
Main operating regions	US, UK/Europe	US, UK, Sweden, South Africa	UK	UK, Saudi Arabia, Australia	UK, Sweden, France, Germany, Italy	UK, France, Germany, Spain, US	Main operating regions
Major markets	US, Global	US, UK/Europe	UK	UK/Europe, Middle East, Australia	UK/Europe	Global	Major markets
Contribution to 2005 Group sales	 23%	 8%	 18%	 18%	 12%	 21%	Contribution to 2005 Group sales
Key points from 2005	<ul style="list-style-type: none"> Sustained leadership positions in electronic warfare and military communications – secured US Air Force mission planning contract Acquisition of largest US non-nuclear ship repair business Successful integration of 2004 acquisitions Successful flight test of infrared missile countermeasures system for commercial airliners 	<ul style="list-style-type: none"> Transatlantic growth with acquisition of United Defense Industries Global land systems business established Key contracts secured – Bradley reset and upgrade – Danish CV90, US RG-31, M777 UK Future Rapid Effect System (FRES) demonstrator award UK cost base being addressed 	<ul style="list-style-type: none"> 37 Typhoon aircraft delivered in the year (12 to UK RAF) First flight of UK Hawk Advanced Jet Trainer aircraft achieved early Successful delivery of F-35 JSF airframe assemblies Type 45 first of class launched in February 2006 Landing Ship Dock (Auxiliary) first ship delivered 	<ul style="list-style-type: none"> Delivery of Saudi strategy on track – Compound construction – Saudi joint venture company formed – Increasing employment of Saudi nationals Government to government Understanding Document signed on Saudi armed forces modernisation Delivery of UK partnered support growth strategy Improved performance from Australian business 	<ul style="list-style-type: none"> Continued restructuring of European business portfolio – Eurosystems transaction completed – Integrated System Technologies formed – Saab stake reduced to 20.5% – Atlas Elektronik sale agreed Revised Gripen International marketing arrangements with Saab 	<ul style="list-style-type: none"> Strong Airbus order intake First flight of A380 long-range airliner Airbus cost reduction programme on track Airbus new product development programmes underway Ongoing losses in Regional Aircraft Aerostructures disposal announced 	Key points from 2005
Location in this report	page 14-15	page 16-17	page 18-19	page 20-21	page 22-23	page 24-25	Location in this report

Chairman's letter

"The executive team and all employees have demonstrated their ability to deliver results and I applaud their hard work and dedication."



Dick Oliver
Chairman

With a combination of effective strategy, continued good programme execution and achievement of key business objectives, including a focus on winning future business, 2005 was a successful year for BAE Systems.

I believe that BAE Systems has evolved a comprehensive and robust process for developing strategy, including appropriate review and challenge by the Board. The Company's strategy, described in detail later in this report, reflects the accomplishment of key objectives in 2005 and establishes the framework for continued performance improvement and growth in future.

There were several noteworthy developments over the past twelve months: first, the acquisition of United Defense in June was a step change in the implementation of our US strategy and establishes BAE Systems as the world's second largest land systems company; second, the Understanding Document signed between the governments of the UK and the Kingdom of Saudi Arabia establishes a framework for modernising the Saudi armed forces, including the supply of Typhoon aircraft; and finally, the publication in December of the UK government's Defence Industrial Strategy recognised the key position of the UK defence industry in supporting the UK's armed forces. These developments, combined with good progress on resolving pension funding issues and

good project execution combined to make 2005 a landmark year for BAE Systems.

In addition to overseeing Company strategy, the Board is responsible for monitoring the Company's performance, maintaining the governance framework, overseeing succession planning for the Board and senior executives, setting appropriate standards of conduct and monitoring compliance with those standards.

Part of my role as Chairman is to ensure the Board has the required skills and experience to carry out these responsibilities in a large international business. With the increasing importance of BAE Systems' operations in the United States, which now manage 35% of sales, we have appointed three new non-executive directors to the Board to provide further US perspective and experience.

Peter Weinberg was a senior director of Goldman Sachs Inc. and is a dual US/UK citizen; Phil Carroll is the former chairman and chief executive officer of Fluor Corporation and is a US citizen; and Roberto Quarta is the chairman of BBA Group plc, a partner of the private equity firm Clayton, Dubilier & Rice and a dual US/Italian citizen.

With the addition of these three new directors, the Board is well equipped to monitor performance and oversee the Company's future strategic development.

Social, environmental and ethical aspects of a company's business operations are increasingly of interest to a broad stakeholder community. In order to advance our leadership in this area, the Board has established a new Corporate Responsibility Committee chaired by Peter Weinberg. A summary of the Company's corporate responsibility performance is included in this Review, supplemented by a detailed Corporate Responsibility Review for 2005, published separately.

The Board is also responsible for setting realistic, yet stretching, targets for management with appropriate incentives for both baseline and stretch performance. These targets include both financial and non-financial objectives and further details are included in the summarised Remuneration Report.

The executive team and all employees have demonstrated their ability to deliver results and I applaud their hard work and dedication. Looking forward, the Company will be operating in a time of challenging defence budgets and our top priority is to deliver continuing performance improvement.

The Board is recommending an increased final dividend of 6.3p per share, making a total of 10.3p for the year. At this level the annual dividend is covered 2.2 times by underlying earnings from continuing operations (2004 1.8 times). Subject to shareholder approval at the 2006 Annual General Meeting, the dividend will be paid on 1 June 2006 to holders of ordinary shares registered on 21 April 2006.



Dick Oliver
Chairman

22 February 2006

Chief Executive's review



Mike Turner
Chief Executive

BAE Systems has performed well against its objectives in 2005. Financial results have been delivered in line with our plan and further significant steps have been taken to implement the Company's strategy. In particular, the acquisition of United Defense builds on our strong defence technology business in the United States and complements our established position as the largest defence company in the UK and Europe.

The United Defense acquisition has elevated BAE Systems to the second largest supplier in the global land systems market. The former United Defense activities have been integrated with BAE Systems Land Systems, which comprised the former RO Defence and Alvis activities including Hagglunds. Integration of these operations has resulted in a single US headquartered global land systems business with operations in the US, UK, Sweden and South Africa.

In 2005, the Company has continued to improve performance through a combination of good project execution, cost and productivity improvements within the business operations together with the benefit of actions over recent years to eliminate inappropriate risk and improve returns, especially in our UK Ministry of Defence (MoD) Programmes business.

The outlook for our UK Programmes business is now good. Following agreement on the way forward for the Typhoon programme, it is now making a significant contribution to the Company's performance. Other UK platform programmes, such as the Type 45 destroyer, Nimrod MRA4, Hawk and Astute submarine, are also expected to progress to make good contributions when they transition from design to production.

Alongside the good operational execution now being delivered we continue to strive to further embed a high performance culture across the Company.

The formation of the Centre for Performance Excellence will help ensure consistency of performance measurement and provide leadership and focus for the sharing of best practice across the Company.

In December, the Company welcomed the publication by the UK government of the Defence Industrial Strategy following extensive consultation with industry. The strategy paper recognises the need for government and industry to work in partnership to secure the best technologies to meet the needs of the UK's armed forces. The paper also identifies the skills and capabilities required to equip and support the UK armed forces whilst ensuring the UK maintains a world class defence industry. BAE Systems recognises that implementing

the Defence Industrial Strategy sets challenges for both the MoD and industry.

Addressing pension deficits is a challenge. Reduced discount rates used to value scheme liabilities and the need to address changes in assumptions for increased life-expectancy combined to create a significant deficit in the funding of the Company's pension schemes.

The Company has recently finalised a plan for the largest of its funds, the Main Scheme. The plan addresses the deficit through increased contributions and benefit concessions from employee scheme members and contributions of cash and property assets from the Company. These actions enable the Company to maintain this defined benefit pension scheme for existing scheme members, at a cost acceptable to the Company, eliminating the substantial funding deficit and introducing flexibility into the benefit structure to self-fund any further increases in employee longevity going forward.

A continuing success for the Company is the provision of defence support solutions. The Company has a large and growing business providing support for armed forces and government agencies. Through-life support and upgrades for in-service defence equipment is expected to become an increasingly important activity for BAE Systems as air, naval and land sector platforms are expected to remain in service for many decades and require progressive upgrades in capability with advances in technology.

In partnership with the MoD's Defence Logistics Organisation (DLO) the Company has continued to develop and grow its support solutions activities for the UK's armed forces. The successful delivery of cost savings, together with improved equipment availability across a number of pilot air systems activities, has enabled the Company to broaden the scope of its DLO support activities to the UK land sector. Further support opportunities have been identified with the potential to deliver further cost savings and improved system availability for our UK customer and to deliver future profitable growth for the benefit of shareholders.

“Financial results have been delivered in line with our plan and further significant steps have been taken to implement the Company’s strategy.”

BAE Systems continues to provide extensive support in the Kingdom of Saudi Arabia, principally to the Royal Saudi Air Force, building on a relationship spanning several decades. We employ some 4,600 people within the Kingdom on wide-ranging activities including flying training and support for aircraft previously supplied. The Company has recently invested in facilities to enhance in-Kingdom capability for the maintenance and sustainment of capability of in-service aircraft.

In December 2005, the governments of the Kingdom of Saudi Arabia and the UK signed an Understanding Document, intended to establish a greater partnership in modernising the Saudi Arabian armed forces and developing close service-to-service contacts especially through joint training and exercises. Under the terms of the Understanding, the two governments recognise the requirement to provide enhanced capabilities to existing military assets and ensure that they can be supported by local industry. It is also intended that Typhoon aircraft will replace Tornado Air Defence Variant aircraft and other aircraft in service with the Royal Saudi Air Force. The details of these arrangements are confidential.

Support is also now a substantial component of our business in the US. Following the acquisition of United Defense, its marine repair business has been added to the Company’s established US Navy and federal systems support activities to form an integrated support solutions business in the US.

Drawing on the depth of experience now residing on both sides of the Atlantic, a cross-company support solutions council has been formed to share best practice.

A number of actions have been taken to rationalise the Company’s portfolio of activities in Europe and to manage non-strategic businesses for optimum value.

In March 2005, BAE Systems agreed a reduced involvement in marketing the Gripen combat aircraft and reduced its equity interest in Saab AB from 34.2% to 20.5%.

The AMS joint venture was restructured with BAE Systems acquiring the UK based operations of AMS and Finmeccanica acquiring the Italian operations. In a related transaction BAE Systems sold its UK based sensor systems and electronic warfare avionics activities to Finmeccanica. The agreement includes the deferred sale of a retained 25% interest in the resulting enlarged avionics business, Selex. The wholly owned UK activities of the former AMS business have been combined with BAE Systems’ other C4ISR activities to form Integrated System Technologies (Insyte).

The integration of systems into digital networks, or Network Enabled Capability (NEC), is transforming defence capabilities. Insyte is working in partnership with the UK MoD, to deliver transformational capabilities to the UK armed forces through the application of emerging NEC technologies.

The sale of Atlas Elektronik, the naval systems business based in Germany, jointly to ThyssenKrupp and EADS was agreed in December 2005 and is expected to complete in the first half of 2006, subject to regulatory approval.

BAE Systems has valuable interests in the MBDA guided weapons joint venture and Airbus.

MBDA continues to perform well with good order intake. A further step in the consolidation of the European guided weapons industry was achieved with the agreement to integrate fully the German missile business LFK into MBDA.

Airbus produced another strong financial performance despite a continued high level of investment in new product development. Order intake was substantially ahead of plan, benefiting from strength in a number of markets including China, India and the Middle East. Aircraft demand has also been stimulated by the enhanced operating economics of new products such as the A380 and A350 airliners now under development.

In summary, we have had a good year, delivering a strong set of financial results and meeting our overall objectives for 2005.

We are successfully executing our strategy. We have further strengthened our position in the United States, restructured our portfolio of business interests in Europe and, through a combination of factors, we now have a much enhanced outlook for our business in the UK. We are delivering shareholder value by being the premier transatlantic defence and aerospace company.

We are now a very well balanced Company, not overly dependent on any one sector but generating good returns for shareholders from a broad base of operations in the world’s key defence and aerospace markets.

BAE Systems is set to deliver good growth and we look forward with confidence to building on our particularly strong performance in 2005 with continued good progress through 2006.

Mike Turner
Mike Turner
 Chief Executive

22 February 2006

Market overview

Defence

Global defence spending grew by eight percent in 2004 among the fifteen largest military nations.

BAE Systems is heavily reliant upon the levels of funding committed by the domestic governments where the Company’s operations are based, principally the US and UK. In addition, export markets are defined and regulated by those governments.

The US represents 45% of the world defence market. It is, and will remain, one of BAE Systems’ key markets, offering programme scale and a high level of investment in research and development. Although growth in US defence spending is expected to slow, the Company is well placed to support the US Department of Defense’s likely emphasis on force sustainment and affordable transformation.

In the UK, BAE Systems is seeing the benefit from its work over recent years to eliminate inappropriate risk and improve returns from its Programmes business with the UK Ministry of Defence (MoD). The Company has continued to deliver wide-ranging support activities in partnership with the MoD’s Defence Logistics Organisation and the armed forces.

The UK customer is undergoing a transformation, driven by the need for greater agility, affordability and more effective technology exploitation. Fundamentally, this transformation is a shift towards integrated capability and managed through-life, to deliver the required military effect.

This evolution is expected to see the scope of industry’s role change as the MoD seeks long-term partnering relationships to deliver through-life capability management as indicated in the recently published MoD Defence Industrial Strategy.

Although defence spending in some western European nations is static, the region still offers significant market opportunities for BAE Systems. In particular, countries in central Europe are investing in their armed forces as they move from Warsaw Pact equipment to NATO standard equipment.

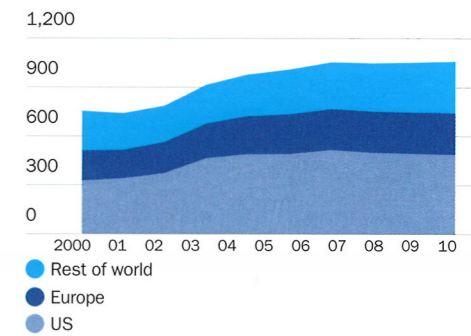
The Kingdom of Saudi Arabia is another major market with the Company serving as prime contractor for the UK government-to-government agreement. BAE Systems provides support to the Royal Saudi Air Force, the Kingdom’s ground defence infrastructure and naval minehunters.

A number of Asian countries represent growth market opportunities and BAE Systems has a long and growing relationship with India.

In Australia, BAE Systems has continued to build on its position as the Australian Defence Force capability partner of choice in integrated military systems and support contracts.

South Africa is another market which continues to offer opportunity to BAE Systems and where the Company has in-country capability.

Forecast defence budget by major region
 (US\$ billions in constant 2006 prices)



Source: BAE Systems internal analysis
 The US represents over 45% of the total forecast global defence spend (including equipment, personnel and operating costs) to 2010.

Aerospace

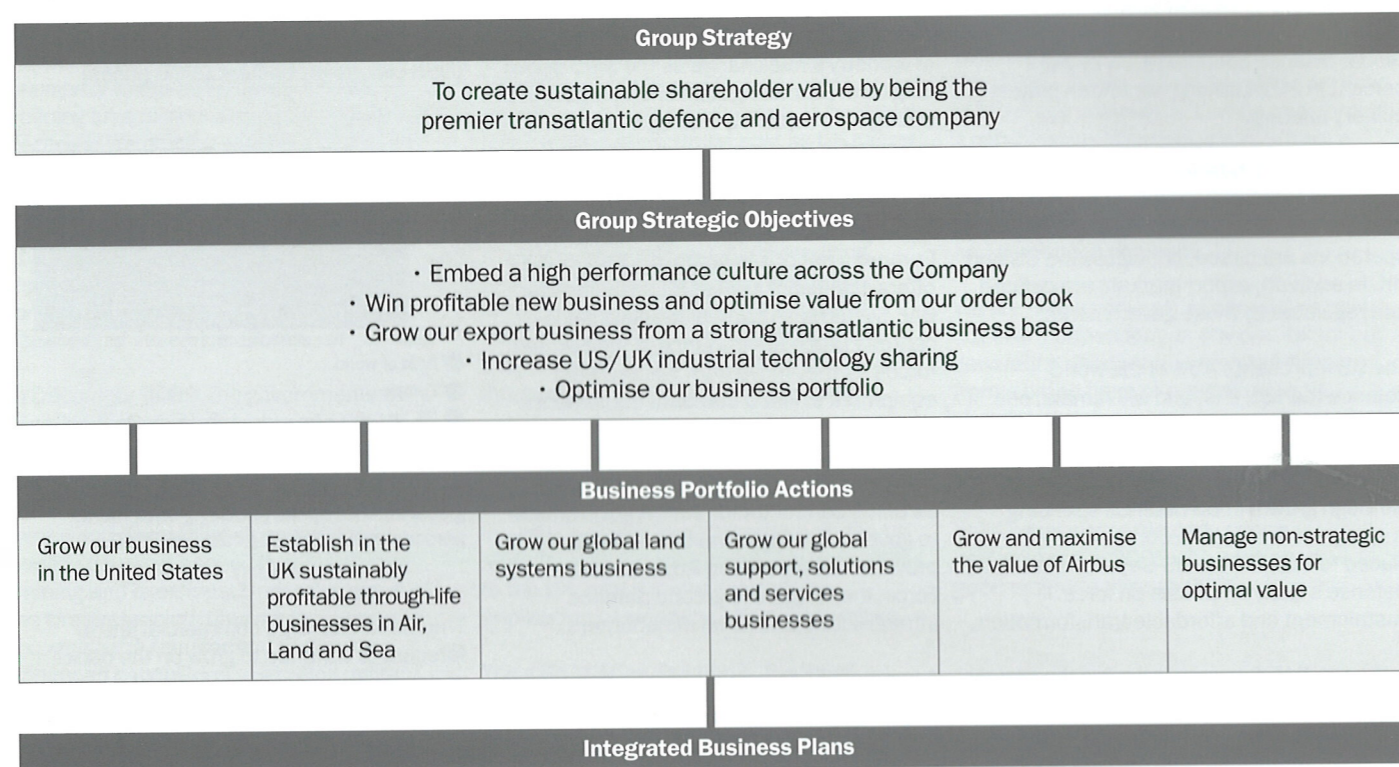
The market for large commercial jets is forecast to continue to grow on the back of rising passenger travel. Annual revenue passenger kilometres are forecast to grow by approximately 5%¹ through to 2023.

The market in 2005 was particularly buoyant, with strong order intake for larger jet aircraft across the industry.

BAE Systems supports a number of regional aircraft supplied in prior years. The leasing market for these smaller aircraft remains difficult.

¹ Airbus forecast (December 2004)

Group strategy framework



BAE Systems' strategy is to create sustainable shareholder value by being the premier transatlantic defence and aerospace company. This is delivered through Group Strategic Objectives, Business Portfolio Actions and Integrated Business Plans. The five Group Strategic Objectives are owned by the Executive Committee and applied across the Group. The Business Portfolio Actions are championed by relevant Executive Committee members and are delivered either separately or jointly by the businesses. Many of our businesses now support more than one portfolio action to encourage them to work together across business boundaries.

What do we mean when we say "sustainable shareholder value"?

"Shareholder value" means growth in our share price and dividends. "Sustainable" means continually reviewing the portfolio of businesses and building a consistent track record of delivery to our shareholders. It also means continually improving the consistency and quality of application of our best practice processes and the skills of our people to enable us to deliver on our commitments to customers and shareholders.

Why "transatlantic"?

"Transatlantic" relates to our most important markets. It means having a presence in both the UK/Europe and in the US. The US, by a very large margin, is the world's largest defence and aerospace market and the largest investor in technology. This technology investment, as well as the scale of the market, is key to our drive to grow in the US. Our other home markets, Sweden, Saudi Arabia, South Africa and Australia, complement our strong transatlantic base.

Why "defence and aerospace"?

While defence remains our core market, our historically strong presence in the aerospace sector, through our holding in Airbus, is a major contributor to the value of the Company.

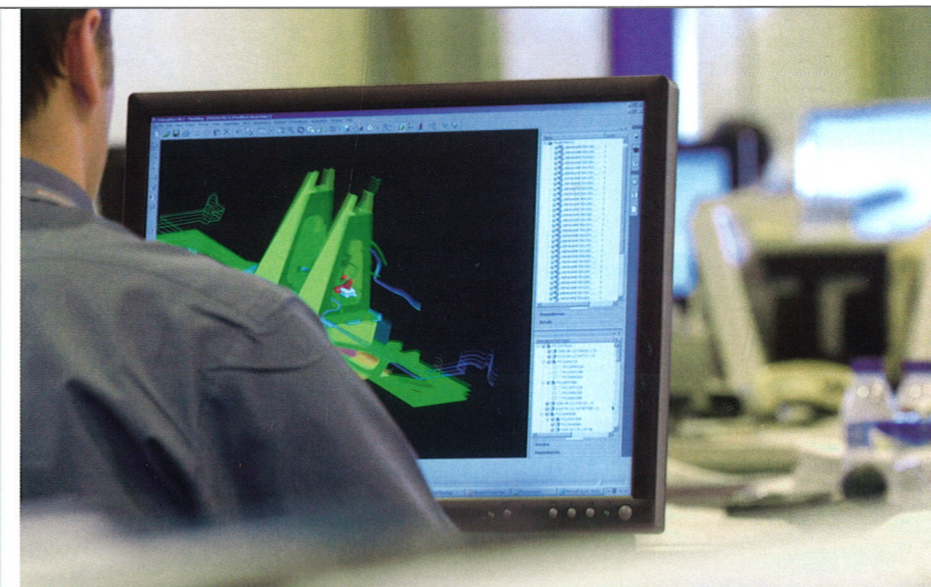
Over half of the Company's total sales are now from electronic systems, software and services. Defence platform programmes contribute roughly a quarter and the balance comes from the commercial aerospace market. On both sides of the Atlantic, defence now increasingly includes Homeland Security markets.

The following pages (7 to 13) describe how we are delivering the strategic objectives and actions that underpin the Group strategy.

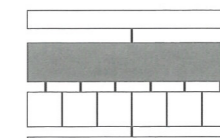
Group strategic objectives

Developing employees

The 'Developing You' programme is at the heart of the continual training and skills development that BAE Systems provides for employees. In 2005 over 1,350 engineers participated in 'Engineering Developing You', a framework which maps engineering capability to an individual's career aspirations and BAE Systems business needs. 'Developing You' now spans most of the business functions and comprises a bespoke range of training modules, many of which are accredited by leading universities and professional bodies.



Embed a high performance culture across the Company



A high performance culture within BAE Systems will be achieved by ensuring that:

- the Company operates with clear governance
- businesses and employees have clear objectives
- best practices are shared across the Company
- benchmark core processes are consistently applied
- appropriate values and standards are applied

BAE Systems is focused on embedding a high performance culture by consistent application of its core assets of governance, processes and values, and identifying and sharing best practices across the Company.

To help achieve this strategic objective, in 2005 the Company formed the Centre for Performance Excellence (CfPE), which is now playing a key role in accelerating the pace of change to achieve higher levels of performance.

The CfPE is introducing a set of Group-wide measures, so that business data can be monitored in a comparable and transparent way, facilitating assessment of progress towards achieving our Group strategy. In 2006, the CfPE will focus on identifying and sharing best practices, in order to foster performance improvement across the Company.

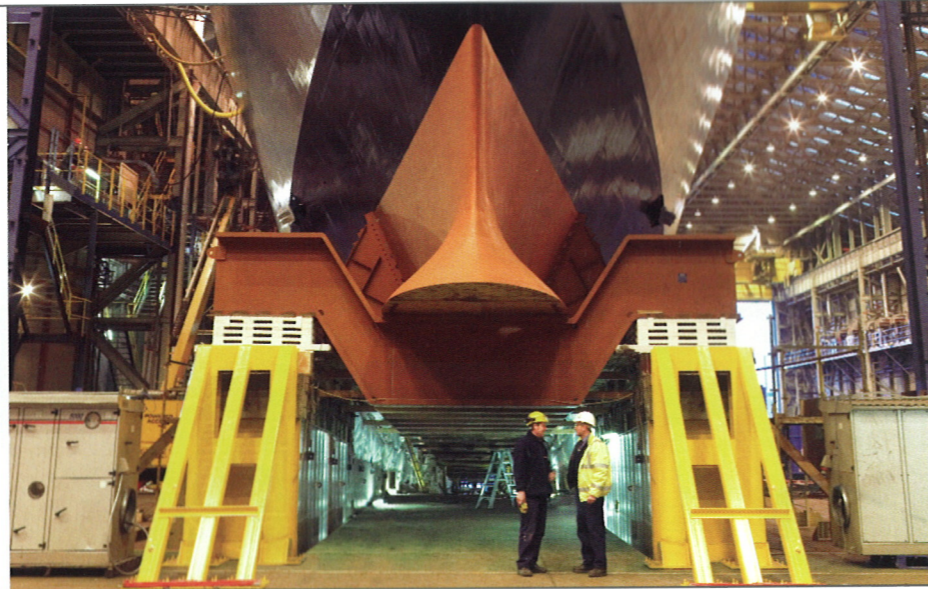
A further aspect of the high performance culture is driven through Performance Centred Leadership (PCL). This is a leadership and performance management system, introduced in 2002, that establishes a clear link between performance and rewards. It establishes an underpinning competency and behaviour set for business leaders, enabling all leaders to understand what 'high performance' means for them and their teams. The system continues to be extended to a wider set of managers to ensure that the principles of PCL are embedded further throughout the Company.

Consistently delivering good programme execution is what drives customer satisfaction, financial growth, and ultimately returns to shareholders.

Group strategic objectives

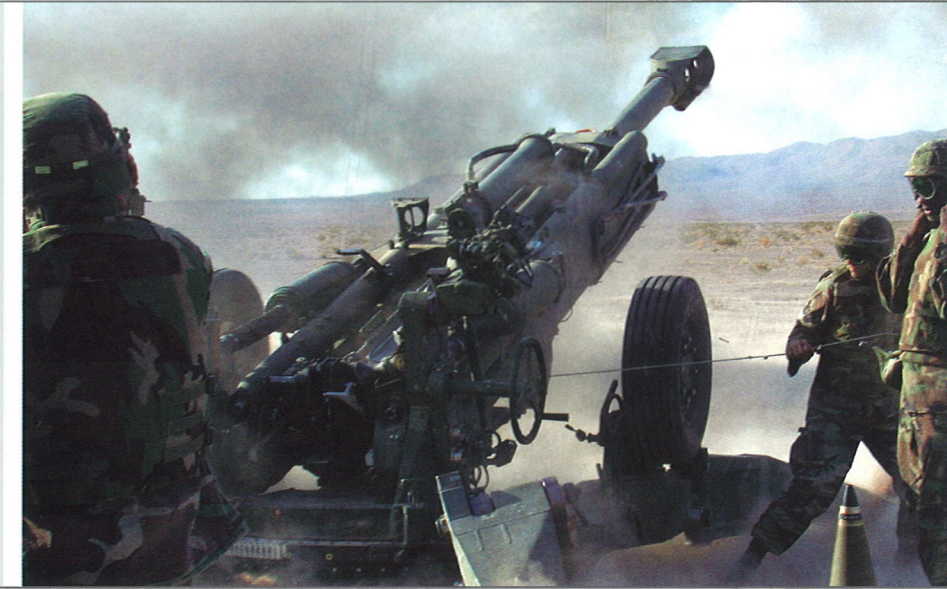
Type 45

HMS Daring was launched on 1 February 2006. It is the first of a planned class of up to eight Type 45 destroyers for the Royal Navy, and will be the UK's next generation anti-air warfare destroyer. Daring has been assembled from large pre-outfitted 'megablock' modules, increasing build efficiency and driving down construction man-hours. The division of work between shipyards across the UK, at BAE Systems' facilities at Scotstoun and Govan in Glasgow and VT Shipbuilding in Portsmouth, has pioneered a new way of building complex warships.

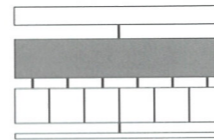


M777

The M777 is the world's first 155mm howitzer weighing under 10,000lbs and meets requirements for rapid deployment and accurate artillery fire support. It has been designed and developed in both the US and the UK and has been selected by the US Marine Corps and US Army as their next generation medium force weapon. M777 is now in full rate production and units have already been delivered to the US Marine Corps, US Army and Canadian Armed Forces.



Win profitable new business and optimise value from our order book



BAE Systems has had considerable recent success in establishing an appropriate balance of risk and reward in its order book, creating a sound foundation for growth and enabling the Company to focus on winning profitable new business.

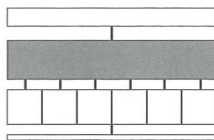
BAE Systems is determined to build on its strong market position by continuing to win business with an acceptable balance of risk and return for shareholders. The progress made in this regard, particularly with major UK programmes, will be sustained for future contracting arrangements, including the anticipated production contracts for Nimrod maritime patrol aircraft, Astute submarines and additional Type 45 destroyers.

A key objective is to deliver greater value to shareholders from our order book by applying best practice, tools and processes in a consistently efficient manner throughout the Company.

The Company's programme execution is being achieved by the consistent application of our Lifecycle Management (LCM) process. LCM lies at the heart of the Company's project management. It provides a powerful and flexible process and control environment within which to execute projects. The LCM process considers the whole life of projects from inception to delivery into service and eventual disposal and provides the framework for the application of best practice programme management.

A key enabler to winning new business is establishing a track record of delivering projects on time, to specification and cost.

Grow our export business from a strong transatlantic business base



Transatlantic markets remain at the core of our strategy given our leading position in the UK/Europe and strong and growing presence in the US. These markets will continue to shape our capabilities and our product and services portfolio and form the basis from which export opportunities can be addressed.

From a strong transatlantic base we shall continue to export to, and work in, markets around the world where we can deliver good shareholder returns. We prioritise key export markets and identify potential products and services which will be better suited to those markets. In addition, the expansion of existing home markets, where our business operations are located, and identification of new ones is a strategic objective for 2006.

The acquisition of United Defense was a key step in our strategy to build BAE Systems' position as the premier transatlantic defence and aerospace company. The Company is now well placed to support the US military's growing emphasis on interoperability, affordable transformation and force sustainment. In particular, the acquisition enables us to address the increasing emphasis on land systems in emerging customer requirements, including the refurbishment, upgrade and long-term support of existing vehicles and equipment.

Following the acquisition of United Defense, we combined our existing land systems activities in the UK, Sweden and South Africa with United Defense to form the Land & Armaments business group.

This created one of the world's leading design, manufacture and support providers of land and armament systems. Less than two years ago, the Company had a small foothold in this sector. BAE Systems is the world's second largest global land systems business, with an annualised turnover in excess of £2bn.

Both organic growth and growth through acquisitions will continue to be pursued in the US.

With its transatlantic foundation BAE Systems is well positioned to grow at the very highest level of technology and capability in the US whilst also delivering value from its strong technology base, capabilities and market position in the UK and its other home markets of Sweden, Saudi Arabia, South Africa and Australia.

Group strategic objectives

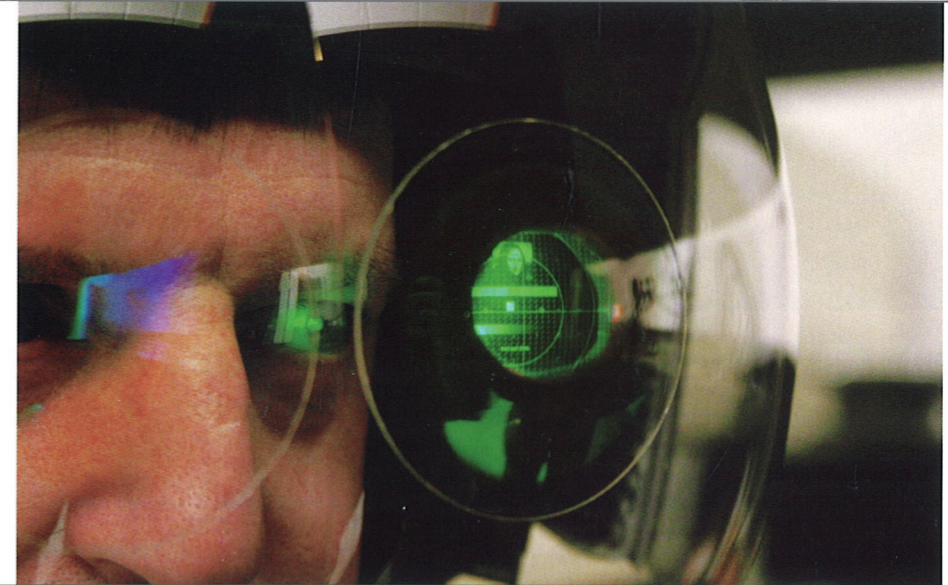
F-35 Joint Strike Fighter (JSF)

BAE Systems' JSF involvement includes delivering the System Development and Demonstration phase of the programme involving airframe assemblies and mission systems. The aft fuselage and empennage for each aircraft are being designed, engineered and built at the BAE Systems Samlesbury site in the UK. The JSF will set new standards for assembly precision and pace. Innovative precision machining techniques help ensure that the JSF meets its stealth requirement. Accuracy is achieved through digital design and manufacturing controls pioneered by BAE Systems.

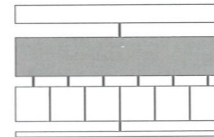


Eurosystems

The Eurosystems transaction, completed in April 2005, achieved BAE Systems' and Finmeccanica's mutual goals of securing control and clear management responsibility for their European defence electronics businesses. Following the transaction, BAE Systems formed Integrated System Technologies by combining the capabilities of the former AMS's UK operations and BAE Systems' C4ISR Networked Systems and Solutions business. This business is working in partnership with the UK MoD to identify opportunities to participate in the transformation of the capabilities of the UK armed forces through the application of emerging network enabled capability technologies.



Increase UK/US industrial technology sharing



The US and the UK have a long history of defence industrial cooperation that has provided significant benefits to both countries. BAE Systems has itself played an important role in that transatlantic cooperation and continues to do so, most notably in the M777 howitzer and F-35 Joint Strike Fighter programmes.

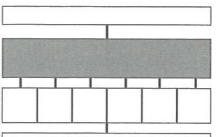
The UK government's Defence Industrial Strategy, published on 15 December 2005, made clear "the importance of transatlantic defence industrial cooperation in enabling both UK and US Armed Forces to acquire more effective military capabilities, at better value for money, than would otherwise be the case, and to cooperate together in pursuit of common security objectives". It went on to say "It is in the interest of both governments and of both industries to improve the current situation".

Notwithstanding the strong tradition of cooperation, the constraints imposed by the current US export control regulations (the International Traffic in Arms Regulations) act as a disincentive to maximising the benefits from such cooperation. While it is self-evident that the movement of sensitive information and technology has generally to be controlled, in today's environment of coalition operations it would be to the advantage of both governments and defence industries to allow and, indeed, to encourage freer technology sharing between the UK and the US.

BAE Systems therefore fully supports the UK government's efforts to establish a technology sharing agreement with the US government that will enable government and industry on both sides of the Atlantic to work more effectively together both to enhance interoperability and to facilitate the delivery of systems that our respective armed forces need.

For BAE Systems an improved technology sharing environment would enable our engineers and scientists in the US and the UK to collaborate more effectively, and bring together their collective skills and expertise to the benefit of our two major customers, the UK and US governments, as well as to our shareholders.

Optimise our business portfolio



To ensure delivery of value to shareholders the Company is focused on determining where appropriate returns can be achieved.

To maximise returns the Company will continue to focus on markets with attractive terms of trade as well as addressing costs, productivity and business performance. To achieve this, businesses operating in markets not considered central to the Company's strategy are managed to maximise their contribution to the Group.

Actions to optimise our business portfolio in 2005 included further restructuring of the Company's activities in Europe and the acquisition of United Defense in the United States.

In Europe, the Eurosystems transaction was completed. This comprised the sale of the UK-based sensor systems and electronic warfare activities of the former Avionics business group and the restructuring of the former AMS joint venture business to exit businesses in Italy and consolidate its UK network enabled capability activities in a wholly-owned UK-based business, Integrated System Technologies.

In March 2005, BAE Systems reduced its interest in Saab AB from 34.2% to 20.5%.

In August 2005, BAE Systems sold Precision Aerostructures, the US based aircraft component machining and fabrication facility.

In December 2005, an agreement for the sale of the Atlas Elektronik business to ThyssenKrupp and EADS was announced.

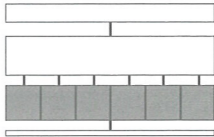
In January 2006, an agreement for the sale of the UK based Aerostructures business to Spirit AeroSystems Inc. was announced.

The acquisition of United Defense was a key step in our strategy to build BAE Systems' position as the premier transatlantic defence and aerospace company. The Company is now well placed to support the US military's growing emphasis on inter-operability, affordable transformation and force sustainment.

Business portfolio actions



The business portfolio actions are championed by relevant Executive Committee members and are delivered either separately or jointly by the business groups.



Grow our business in the United States

In the summer of 2005, BAE Systems completed the acquisition of United Defense, growing the US business base by \$2.6bn in annual sales and 8,000 additional employees. This acquisition established BAE Systems as a major land systems prime contractor with a strong position in support of the US Department of Defense's requirements for force sustainment and affordable transformation. The acquisition provides new opportunities in land vehicle and naval gun programmes. It also broadens our access to platforms, supporting our customers with enhanced solutions including new target acquisition, communications and networked awareness systems, and diversifies our business base with the US Army.

In addition, the existing US business is achieving organic growth across its established businesses with key successes in electronic warfare, tactical communications, intelligence systems, information technology, and customer support.

Establish in the UK sustainably profitable through-life businesses in air, land and sea

Good progress continues to be made across all major platform programmes. In 2005, the financial performance of the Programmes business group benefited both from improved project execution and agreement on the way forward on the Typhoon programme made in December 2004.

In December 2005, the UK MoD published its Defence Industrial Strategy (DIS). This strategy will shape the future of the UK defence industrial base and recognises the need to sustain in the UK the highest system integration skills and capabilities across air, land and sea domains. The DIS also emphasises the importance of a through-life capability approach and envisages long-term partnering agreements within each of the key sectors of air, land and sea. Successful implementation of this strategy will create a positive investment environment. The Company will work closely with the MoD to help them realise the DIS intent.

The enduring requirement for retaining an on-shore, through-life, prime systems integration capability across air, land and sea presents BAE Systems with opportunities to sustain its UK business base.

Grow our global land systems business

Following the successful completion of the acquisition of Alvis in 2004 and United Defense in 2005, BAE Systems has established a major land systems position, with home markets in the US, Sweden, South Africa and the UK. The formation of the Land & Armaments business group in June 2005 brought BAE Systems' existing land systems activities together with those of United Defense, to create a global leader in armoured combat vehicles and armaments.

These integrated capabilities, our position on future programmes and our extensive installed base of legacy systems provides BAE Systems with a platform from which it can develop its global land systems business. We shall capitalise on the reset and modularity priorities of the US Army to restore battle-worn equipment and to convert active and reserve units to standardised expeditionary organisations. The next generation of combat systems will be rapidly deployable, lethal, survivable and networked. We have an integral role in the UK's Future Rapid Effect System programme, the US Army's Future Combat Systems programme and the Swedish SEP future ground systems programmes.

In the UK land support arena the award of the AS90 equipment support contract was an excellent first step as we enter a long-term partnering arrangement with the MoD to support the UK armoured fighting vehicle fleet.

Grow our global support, solutions and services business

In the UK, Customer Solutions & Support (CS&S) has continued the evolution of its successful partnering relationship with the UK Defence Logistics Organisation. This relationship is underpinned by a partnering arrangement which is being refreshed to reflect the drive for through-life capability management as emphasised in the DIS. The CS&S International and Australian businesses continue to implement their growth strategies.

Good progress has been made with the Kingdom of Saudi Arabia, where the Company employs some 4,600 people, in particular with the signing of the government to government Understanding Document in December 2005.

Restructuring in the US led to the creation of the US Customer Solutions organisation, strengthening our position to address emerging support opportunities. The US business is focused primarily in the areas of technology solutions and services, Information Technology (IT), and ship repair. While the US services market is large, it is generally flat, resulting in a very competitive environment. Future growth plans remain centred in the high growth IT market.

BAE Systems is in an excellent position to grow business by assisting customers with defence logistics transformation to increase operational effectiveness.

Grow and maximise the value of Airbus

In addition to its 20% equity interest in Airbus, BAE Systems continues to exercise important management influence on the business. Airbus achieved good growth in 2005. It secured net new orders for 1,055 aircraft in 2005, including firm orders received from China, Kingfisher Airlines, UPS and Virgin Atlantic.

In 2005, Airbus delivered 378 aircraft compared to 320 in 2004. The 2005 total comprised 289 single-aisle A320 family aircraft and 89 wide-body and long-range airliners (essentially A330s and A340s).

In April 2005, the first A380 successfully undertook its maiden flight. The entry into service for the A380 is now expected in late 2006.

Development of the A400M military transport aircraft continues, with the first export order for the aircraft achieved during 2005.

Following approval from its shareholders, EADS and BAE Systems, Airbus formally launched the new long-range A350 airliner in October 2005. Airbus has already received 172 firm orders and commitments.

Manage non-strategic businesses for optimal value

Where a business is operating in a market that is not contributing to achieving our desired long-term strategic positioning it will be managed to optimise value. This could mean focusing on managing for cash or divesting the business. Whatever the chosen action, such businesses will be managed to maximise their contribution to the overall Group performance.

A number of disposal transactions were agreed during 2005.

Electronics, Intelligence & Support

Electronics, Intelligence & Support (EI&S) is headquartered in the US, and is responsible for the former businesses of BAE Systems North America, the group's UK-based displays and inertial systems activities and US marine repair activities. EI&S comprises two businesses, Electronics & Integrated Solutions and Customer Solutions.

During 2005, Electronics, Intelligence & Support achieved EBITA² of £324m (2004 £256m) on sales¹ of £3,697m (2004 £3,063m). The business group generated operating cash inflow³ of £323m (2004 £190m).

Electronics & Integrated Solutions

The Electronics & Integrated Solutions (E&IS) business is a major defence and aerospace electronics business with products and services encompassing:

- Communications, including tactical networking
- Electronic warfare, including electronic protection and information warfare
- Avionics and controls
- Sensors
- Integrated systems

E&IS is an industry leader in a variety of military communications, electronic identification, navigation and guidance systems. The Company has wide technical expertise in C4ISR⁶ and C3I⁷ systems and

is a provider of network centric warfare solutions to command centres, platforms and individual soldiers in the battle space. It has a prominent position integrating communications on the US Army's Future Combat Systems, including provision of an Integrated Global Positioning and Inertial Navigation System for the programme. In 2005 the Company was also selected to provide the new mobile military communications system for the Slovak armed forces.

The Company is a major supplier of integrated avionics systems for military aircraft. Such systems include the electronic countermeasures for the US Air Force's F-22 Raptor and development of the electronic warfare suite for the F-35 Joint Strike Fighter. In 2005 the Company was selected by the US Navy to develop the Tactical Aircraft Directable Infrared Countermeasures system and has been successfully flight testing a related infrared missile countermeasures system for commercial aircraft.

E&IS provides signals and information management solutions for defence and government agencies. Its Diamond Software product family architecture underpins the latest generation of electronic support measures for the UK Shaman communications programme. The Company's radiation hardened computers have guided spacecraft on missions to Mars and to intercept a comet.

As a market leader in advanced information technology, geospatial exploitation software and data production, integration of knowledge-based systems and avionics test equipment, the Company was selected as one of the prime contractors for the US Air Force mission planning consolidation in 2005. Another programme, Gridlock, gives the war fighter distinctive advantages with its 'smart imaging' targeting that rapidly generates accurate target coordinates using still or motion imagery from tactical manned and unmanned platforms.

Capabilities in vehicle management, human-machine interface, precision guidance and power systems provide improved operational safety and enhanced mission effectiveness. Contract awards in 2005 included the digital electronic engine controls for the GE T700 engine that will make BAE Systems the leader in the army helicopter segment.

BAE Systems also provides the HybriDrive propulsion system, used on commercial buses, which improves fuel economy by 35% and dramatically reduces emissions. Five hundred systems for operation in New York City were ordered in 2005. In a related technology, the US Office of Naval Research selected BAE Systems to develop an on-board power system for the Marine Corps' High-Mobility Multipurpose Wheeled Vehicle (the Humvee).

Advanced Airborne Systems

BAE Systems designs, develops and manufactures a wide range of electronic systems and subsystems for both military and commercial applications. The Electronics & Integrated Solutions business develops advanced airborne systems, including the electronic warfare suites for the F-35 Joint Strike Fighter (JSF), F-22 Raptor and other air platforms. In July 2005, BAE Systems successfully completed the first flight test of its F-35 electronic warfare (EW) suite.

The tests were funded internally and outside of the JSF programme flight test schedule in order to evaluate potential cost savings and performance improvement options. To date, the EW system continues to exceed all contract performance metrics within the System Design and Development phase.



The Company is a supplier of state-of-the-art infrared, millimetre-wave, and laser technologies for missile seekers, guided munitions, and target designators. It is upgrading the technology for the Theater High Altitude Area Defense (THAD) seeker for Lockheed Martin. In an important entry point to the \$1bn military thermal imaging market, the Company is producing the new thermal weapons sights to equip the US Army and Marine Corps, and is to manufacture the TIM1500 thermal imaging module for the US Army's Stryker armoured vehicle.

In 2005, BAE Systems won the US Air Force's key Design and Engineering Support Program II, leveraging expertise in aircraft modifications and operations.

The business operates two technology organisations focused on enhancing its technology base, Advanced Systems and Technology and the Center for Transformation.

Advanced Systems and Technology identifies strategic technology needs and delivers that technology in four major domains: Sensors and Signal Processing; Radio Frequency; Electro-Optical and Infrared; and Networking and Information Processing. Major customers include the US Defense Advanced Research Projects Agency and other government laboratories, with research and development programmes ranging from multi-functional low-observable

antenna systems to high performance scalable signal processing technologies, mixed-signal (digital, RF and optical) devices, and advanced sensors.

The Center for Transformation focuses on development of advanced programmes and concepts in the C4ISR⁶ domain and deploys leading-edge technology solutions to solve time-critical problems.

Customer Solutions

Customer Solutions comprises three business units:

- BAE Systems Information Technology (IT)
- Technology Solutions and Services (TSS)
- BAE Systems Ship Repair

IT capabilities include enterprise-wide managed IT operations, mission-critical performance and information analysis and assured delivery. TSS provides services including system engineering and technical assistance, system and sub-system integration and operations and maintenance. Ship Repair provides non-nuclear ship repair, conversion and modernisation, principally in the home ports of the US Navy.

The business provides a broad range of services in the areas of systems integration, systems engineering and technical assistance, operations and maintenance and logistics. It also develops communications systems and precision

tracking radars, is one of the largest suppliers to the US Navy, is a leader in air and missile defence systems and is one of the world's largest manufacturers of explosives. It also includes the US's leading non-nuclear ship repair company.

During 2005, the major projects for the US government included a blanket purchase agreement for the supply of information technology support and services, a cost-plus award fee/level of effort contract for operations, and maintenance support for IT systems. Combined annual sales for these are estimated at \$94m.

TSS provides professional engineering services to the NAVSEA DDG51 Shipbuilding Program Office under a \$863m contract which will run until 2015. It also handles the SETAC contract, for which the primary customer is the Army Space and Missile Defense Command. The full year sales for SETAC are \$90m.

Ship Repair has continued to support the US Navy repairs, alterations and continuous repair work on Landing Platform Dock/Landing Ship Dock (LPD/LSD) class vessels in San Diego, as well as similar LSD Multi-Ship Multi-Option in Norfolk, Virginia.

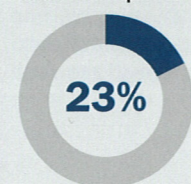
Electronics, Intelligence & Support – Summary

Financial highlights

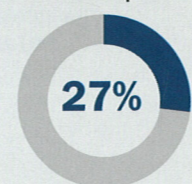
- Organic sales growth of 6% over 2004
- Return on sales improved to 8.8%
- Good conversion of EBITA² to operating cash flow
- Order book growth

	2005	2004 ⁵
Sales ¹	£3,697m	£3,063m
EBITA ²	£324m	£256m
Cash inflow ³	£323m	£190m
Number of employees ⁴	32,900	30,000
Order book ¹	£3.5bn	£3.1bn

Share of Group sales⁴



Share of Group EBITA²



Key points

- Sustained leadership positions in electronic warfare and military communications – secured US Air Force mission planning contract
- Acquisition of largest US non-nuclear ship repair business
- Successful integration of 2004 acquisitions
- Successful flight test of infrared missile countermeasures system for commercial airliners

Looking forward

Defence spending in the US continues to be robust for the near term, however fiscal pressures may make the budget environment more challenging in subsequent years. Customers will need to balance priorities to equip effectively the current fighting force, whilst developing capabilities to transform the future force.

EI&S was reorganised in 2005 to enable it to compete more effectively. The business group can now leverage a breadth of capability in critical domains, whilst rapidly aligning technologies and resources to those sub-segments of the market which are likely to see higher than market growth.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards
⁶ Command, Control, Communications and Computing, Intelligence, Surveillance and Reconnaissance
⁷ Command, Control, Communications and Intelligence

Land & Armaments

The Land & Armaments business group, headquartered in the US, is a global leader in the design, development, production and service support of armoured combat vehicles, major and minor calibre naval guns, missile launchers, canisters, artillery systems and intelligent munitions.

During 2005, Land & Armaments achieved EBITA² of £42m (2004 £(8)m) on sales¹ of £1,270m (2004 £482m), and generated an operating cash inflow³ of £168m (2004 £60m).

This group was established in June 2005 from the newly acquired United Defense and the existing Land Systems (formed by the integration of RO Defence and Alvis in 2004). This global business has operations in the US, UK, South Africa and Sweden, with markets in more than two dozen countries.

The Land & Armaments business is shaped by the contracts awarded for its products by primarily the governments of the US, the UK and Sweden. The success of the business results from its history of securing key government contracts and the ability to satisfy customer needs in its various home and export markets. In the US, the Army's requirement to restore its current systems to combat-ready condition following extensive operational use and to upgrade and remanufacture to the most advanced

configurations is the subject of one of the largest ongoing programmes being undertaken by the group.

Land

Contract awards on current systems have been exceptional. Most noteworthy were the orders in 2005 worth some \$1.5bn for the refurbishment and upgrade of Bradley and M113 fighting vehicles, demonstrating the value and potential of the United Defense acquisition. Other contracts on current systems included the remanufacture and upgrade of 59 M88A2 HERCULES Improved Recovery Vehicles.

The M777 lightweight 155mm howitzer, 495 of which were ordered for the US Marines and US Army in 2005, has now expanded its market with the first delivery of guns to the Canadian Department of National Defense.

In addition to mine protection, current survivability programmes include an armouring programme of M113 personnel carriers in Iraq, the manufacture and installation of Transparent Armour Gun Shield kits for Humvees, trucks, M2 Bradleys, M1 Abrams and add-on armour for the Stryker.

In the area of development, Land & Armaments is well positioned for key future forces programmes including the Future Combat Systems (FCS) programme for the US Army, Future Rapid Effect System programme for

the UK and the Swedish Modular Armoured Tactical System.

Land & Armaments continues to make substantial progress on the development and maturation of the Non-Line-of-Sight-Cannon (NLOS-C), the lead system of the US Army's FCS manned ground vehicles. In 2005, company engineers and the Army completed functional and preliminary design reviews. The NLOS-C remains on track to deliver prototypes in 2008 and achieve system fielding in 2010.

Other contract wins and ongoing development programmes related to Manned Ground Vehicles for the US Army's FCS include the Integrated Army Active Protection System and the common Traction Drive Subsystem for all FCS manned ground vehicles.

The group secured two key contracts in robotic systems – the acceleration of the FCS Armed Robotic Vehicle (ARV), together with Carnegie Mellon University, and the US Marine Corps' Gladiator Tactical Unmanned Ground Vehicle. It also showed its own internally-developed Armed Robotic Demonstrator at the annual meeting of the Association of the US Army.

In the UK, the award of the AS90 Equipment Support Contract followed by the contract to upgrade 500 of the British Army's FV430 tracked vehicles, are key enablers in

becoming the through-life support and capability provider to the UK armed forces.

In the UK and export markets Trojan, an obstacle-crossing vehicle and Titan, a tank bridgelayer, are both based on Challenger 2. Roll-out of the first production vehicles is scheduled for the first quarter of 2006.

Over the past ten years, some £25m has been invested in developing insensitive munitions technology and in UK production facilities. The first contract was awarded in 2005 by the UK MoD for the manufacture of 105mm improved ammunition for the L18 Light Gun. Subsequent awards have been contracts to qualify 155mm ammunition for the L15 and L21 and 4.5" improved ammunition.

The premium that militaries are placing on accuracy and precision in both area and point target fires has raised the importance of intelligent munitions for artillery and mortar systems. Land & Armaments has a leading role in the accelerated fielding of Excalibur to US and Canadian forces in Iraq and Afghanistan. BONUS, a sensor fused 155mm munition fielded in Sweden and France, is being evaluated by the US and UK.

BAE Systems' operations in Sweden continue their strong presence in the northern European armoured fighting vehicles market with further orders for the CV90. The newest customer, Denmark, brings to six the number of European

Non-Line-of-Sight-Cannon (NLOS-C)

The fully automated NLOS-C will deliver more firepower with greater effects faster and more accurately than ever before. BAE Systems is proving new capabilities on the fully automated, 38 calibre NLOS-C Concept Technology Demonstrator, which has fired more than 1,900 rounds at Yuma Proving Ground, Arizona. The first NLOS-C Increment 0 prototypes are scheduled for delivery in 2008.

(Artist's impression)



countries fielding this highly successful infantry fighting vehicle.

The growing international need for mine-protected vehicles has generated orders for the four-wheeled RG-31 from South Africa including the sale of 148 vehicles to the US with further exports to Canada and the United Arab Emirates under contract.

Naval

One immediate benefit of the United Defense acquisition for BAE Systems was the opportunity to meet the US Navy's urgent need for a superior medium-calibre gun and ammunition for the DD(X) next-generation destroyer and the Coast Guard's Deepwater modernisation programme. Both have selected the Land & Armaments' 57mm Mk 110 as a close-in gun system for the DD(X) and as the main battery for the Maritime Security Cutter Large. Partnering with Northrop Grumman Ship Systems, the first Mk 110 will be delivered in December 2006. The weapon system is also baselined on both the General Dynamics and Lockheed Martin designs for the Littoral Combat Ship for the US Navy.

Development of the 155mm Advanced Gun System (AGS) and the Long Range Land Attack Projectile (LRLAP) for the US Navy continues to support Navy and Marine Corps expeditionary and joint operations forces engaged near the coastline and deep inland. The AGS will be capable of a maximum

sustained firing rate of 10 rounds per minute at ranges of up to 60 nautical miles with an objective of being able to reach targets beyond 80 nautical miles. In 2005, the engineering development models successfully demonstrated the key requirements to support the DD(X) ship design. Tests have already established the propulsion approach for the LRLAP needed to meet the challenging range targets.

In addition to key new gun systems, BAE Systems is designing and testing a new Vertical Launching System (VLS), Mk 57. This next generation VLS will provide capabilities for the DD(X) ship to launch a wide range of missile designs.

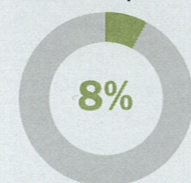
Land & Armaments – Summary

Financial highlights

- Sales of £625m from acquired United Defense business
- EBITA² stated after UK rationalisation charge of £24m
- Cash flow benefits from advance payments secured
- Order book growth

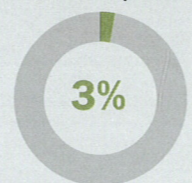
	2005	2004 ⁵
Sales ¹	£1,270m	£482m
EBITA ²	£42m	£(8)m
Underlying EBITA ⁶	£86m	£(2)m
Cash inflow ³	£168m	£60m
Number of employees ⁴	10,600	4,800
Order book ¹	£4.4bn	£2.2bn

Share of Group sales⁴



includes six months of United Defense

Share of Group EBITA²



Key points

- Transatlantic growth with acquisition of United Defense
- Global land systems business established
- Key contracts secured – Bradley reset and upgrade – Danish CV90, US RG-31, M777
- UK Future Rapid Effect System (FRES) demonstrator award
- UK cost base being addressed

Looking forward

Land & Armaments is expected to contribute growth in 2006 driven largely by the ongoing requirements in the US to both reset and upgrade the Bradley family of vehicles. Reset is the need to repair vehicles to return them to a fully operational condition as a result of wear incurred by sustained military operations. Upgrade activity is enhancing the vehicles' mobility, lethality and survivability to support effectively the US Army as it drives to deploy a modular force.

In the UK, there will be continued emphasis on improving profitability and establishing a role on the Future Rapid Effect System programme. The businesses in both Sweden and South Africa continue to perform well in both home markets and in securing export opportunities.

In the longer term, progress on the US Army's Future Combat Systems programme, where BAE Systems has a major role for both manned and unmanned vehicles, will be a major sensitivity for the business.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards
⁶ earnings before amortisation and impairment of intangible assets, uplift on acquired inventories, finance costs and taxation expense

Programmes



The Astute class submarine.
(Artist's impression)

The Programmes business group is a major contributor to the defence of the UK, with the MoD its principal customer. The business group comprises the Company's air systems, naval ships and submarines activities together with the Company's participation in the UK's Future Carrier (CVF) programme.

During 2005, Programmes achieved EBITA² of £133m (2004 £10m) on sales¹ of £2,819m (2004 £2,219m), and generated an operating cash inflow³ of £285m (2004 £442m).

Air Systems

The principal Air Systems programmes are:

Typhoon

The introduction of the Typhoon to the Royal Air Force (RAF) was successfully implemented under the Case White initial support arrangement. The contracted flying hours were completed ahead of schedule, and the first two RAF squadrons have now been deployed to their operational base at RAF Coningsby. A total of 74 aircraft have been accepted by the air forces of the four partner nations for deployment to operational and training squadrons across Europe. Discussions are underway regarding further development to enhance the capability of the aircraft. In addition to the sale of 18 aircraft to Austria, further export possibilities are being pursued.

Hawk

The Hawk Advanced Jet Trainer (AJT) development programme made good progress during 2005, with a successful maiden flight for the first RAF Mk 128 in July, two months ahead of schedule. A production order is expected in 2006. Export contracts for Bahrain, South Africa and India were progressed during the year.

Nimrod MRA4

Nimrod passed a number of key milestones in 2005, and the development fleet of three aircraft continues its extensive flight testing programme. Design and development continues to meet the targets to support the production bid, which was submitted in July, and to serve as the technical baseline for future work.

F-35 Joint Strike Fighter (JSF)

Air Systems is partnered with Lockheed Martin and Northrop Grumman on the JSF programme, with responsibility for the design and manufacture of the rear fuselage and empennage. Work progressed on the system development and demonstration contract, with the successful delivery of the first rear fuselage and empennage to Lockheed Martin. The first conventional takeoff and landing flight is planned for 2006. Activity has also continued in preparation for the bid for the first JSF production contract, with the contract award expected in 2007.

Unmanned Air Vehicles (UAVs)

In July 2005, the MoD formed the Strategic UAVs (Experiment) integrated project team. This will assemble evidence to allow the UK to make informed decisions about the potential role of UAVs in future force mixes. BAE Systems has been selected as prime contractor, and has received a series of contracts for de-risking work.

Astute

Demanding targets and a modular build strategy have combined during 2005 to achieve the accelerating production schedule for the Astute submarine project. Recognition of the challenges of commissioning a first-of-class submarine has driven high achievement in the build and integration stages to de-risk the programmed delivery date of August 2008.



Naval Ships and Submarines

The principal Naval Ships and Submarine programmes are:

Type 45

The Company is the prime contractor and design authority for the Type 45 destroyer, which will be the largest and most powerful anti-air warfare destroyer ever deployed by the Royal Navy. Of a projected eight ships, six are under contract of which the first, HMS Daring, was launched in February 2006. Build on ships 2 and 3 is progressing well, with anticipated build efficiencies already being achieved between first and second of class.

LSD(A)

Two Landing Ship Dock (Auxiliaries) for the Royal Fleet Auxiliary (RFA) are under contract. The first, RFA Mounts Bay, was handed over in December 2005; and RFA Cardigan Bay will be delivered in mid-2006.

OPV

The customer's refusal to accept the three Brunei Offshore Patrol Vessels is now subject to arbitration.

Astute

The Astute programme has achieved milestones on or ahead of schedule throughout the year with closure of the pressure hull now complete. In 2005, every module was shipped ahead of schedule with

the main propulsion package shipped 40 days early in June, the command deck module 5 weeks early in November, while shop floor led innovation enabled the bridge fin and casings to be completed 22 weeks early in October 2005. An innovative all-employee bonus scheme has strongly contributed to this performance.

CVF

The CVF project will be executed within an Alliance structure comprising MoD, BAE Systems, VT Group, Babcock, Thales and KBR. Within the Alliance framework, BAE Systems continues to play a significant role in the leadership and execution of the CVF project. The Roles and Responsibilities agreement signed in December 2005 formally appointed BAE Systems to lead the overarching design and integration of the two ships, as well as continuing to lead the mission systems elements of the project. From a shipbuilding perspective, BAE Systems will design and build two of the four major blocks at both its facilities in Glasgow and in Barrow.

The MoD has approved a further £300m for the next phase (Demonstration Phase Contract) which will fund the Alliance for a further 18 months for continued design evolution and procurement of long-lead materials.

Programmes – Summary

Financial highlights

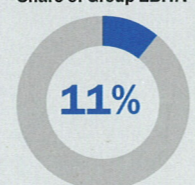
- Sales growth of 27% over 2004
- Margin recovery to 4.7% including £30m benefit from risk retirement on Typhoon
- Margin constrained
 - No contribution from Astute and Nimrod sales
 - No margin traded on Type 45 with programme at an early stage
- Good cash performance

	2005	2004 ²
Sales ¹	£2,819m	£2,219m
EBITA ²	£133m	£10m
Cash inflow ³	£285m	£442m
Number of employees ⁴	16,200	15,700
Order book ⁵	£12.3bn	£13.0bn

Share of Group sales¹



Share of Group EBITA²



Key points

- 37 Typhoon aircraft delivered in the year (12 to UK RAF)
- First flight of UK Hawk Advanced Jet Trainer aircraft achieved early
- Successful delivery of F-35 JSF airframe assemblies
- Type 45 first of class launched in February 2006.
- Landing Ship Dock (Auxiliary) first ship delivered

Looking forward

The future of Programmes is closely linked to the future requirements of the UK's armed forces as well as its ability to generate profitable export business.

For Air Systems the outlook is for reduced sizes of aircraft fleets, leading to increasing levels of weapons system upgrades, as customers seek to incorporate technological improvements into existing platforms. There is continued demand for training aircraft offering improved cost effectiveness and the ability to train operators for the latest combat aircraft. In the UK this need is being addressed by the advanced mission training capabilities of the Hawk Mk128. There is increased interest in the potential of UAVs.

In the naval domain, the CVF programme and the longer term Military Afloat Reach and Sustainability (MARS) programme to replace the RFA fleet with new ships by 2020 offer encouraging growth prospects. BAE Systems is a key participant in the UK government's Maritime Industrial Strategy review.

In the medium to longer term, growth prospects are dependent on anticipated higher activity, as UK development programmes move to production, and the potential for Hawk, Typhoon and naval ships exports.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards

Customer Solutions & Support



Delivering upgraded ex-Royal Navy Type 22 frigates for Romania.

The Customer Solutions & Support (CS&S) business group provides support solutions for current and future requirements. It addresses the trend within armed forces to work more closely with industry to optimise their military capability in the most effective manner. Key capabilities include the integration and delivery of effective supply chain and logistics management, spares, maintenance, repair and overhaul, capability upgrade, technical information services, facilities management and manpower services. CS&S is the prime contractor on the Al Yamamah programme.

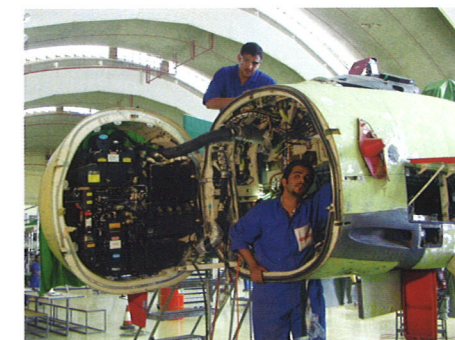
During 2005, CS&S achieved EBITA² of £419m (2004 £497m) on sales¹ of £2,923m (2004 £2,856m), and generated an operating cash inflow³ of £850m (2004 £1,102m).

As previously indicated, margins have been reduced within the Al Yamamah support operations as the programme embraces greater indigenous Saudi content in repair and overhaul work.

BAE Systems has a major presence in Saudi Arabia, as prime contractor for the UK's largest export contract. The contract includes the provision of aircraft and associated hardware, radar and communications support, manpower training and infrastructure for the Royal Saudi Air Force. The business group employs some 4,600 people in the Kingdom of Saudi Arabia, of whom more than half are Saudi nationals. Performance on the programme in Saudi Arabia remains on plan. The Company continues to develop a greater indigenous presence in Saudi Arabia and has made a number of investments in offset companies. The security of our employees is the highest of our priorities and a significant investment is being made in new residential facilities and increased security measures.

Saudi Arabia

BAE Systems is providing a comprehensive defence package to Saudi Arabia under the long-running Al Yamamah contract and CS&S has played a key role in providing training for local people. The proportion of Saudi nationals now working on the contract has exceeded 50% – an important objective for the Saudi government.



In the UK, CS&S has continued the evolution of its successful partnering relationship with the UK Defence Logistics Organisation (DLO) during 2005. This relationship is underpinned by a partnering arrangement which is being refreshed to reflect the drive for through-life capability management as emphasised in the UK's Defence Industrial Strategy.

Key highlights in the air domain include securing major orders on VC10, Harrier, a major third-party support contract on E3D Sentry and Tornado.

A joint DLO/BAE Systems team gained MoD approval in November for the next phase of Tornado support to deliver increased availability and operational flexibility at much reduced cost. This ATTAC programme (Availability Transformation: Tornado Aircraft Contract) will integrate all non-engine Tornado support and upgrade activity into one incentivised arrangement.

In the Naval domain, BAE Systems secured the sale of three ex-Royal Navy frigates to Chile. This follows the successful reactivation and upgrade of the two Type 22 frigates for Romania completed on schedule in April 2005.

In addition, the naval joint ventures continue to perform strongly. BAE Systems has 50% interests in Fleet Support Limited and Flagship Training Limited. These support and services joint ventures form an integral part of the CS&S strategy. Flagship Training Limited, which manages the Royal Navy training establishments and markets their courses to overseas customers, has had another strong year. Fleet Support Limited also continued to perform well underpinned by the partnering agreement at the UK's Portsmouth naval base.

CS&S continues to develop a coherent information and logistics infrastructure in support of both new and in-service systems. Trilogi, a web-based documentation system jointly developed by BAE Systems and the DLO, has now been selected for more than 20 UK MoD programmes and the F-35 Joint Strike Fighter (JSF).

In July 2005, the MoD announced that Defence Logistic Solutions (DLS), in which BAE Systems was a partner, was unsuccessful in the bid for the Future Defence Supply Chain initiative.

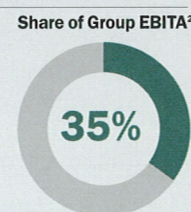
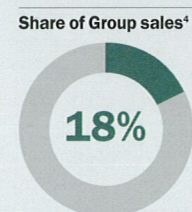
BAE Systems' Australian business has made considerable progress in realising its strategy of becoming the Australian Defence Force's capability partner of choice in integrated military systems and support solutions. An important milestone is agreeing the wider industrial participation with Boeing on the Wedgetail programme and with Lockheed Martin on JSF.

Customer Solutions & Support – Summary

Financial highlights

- Sales growth of 2% over 2004 (18% from non-Al Yamamah activity)
- EBITA² lower on reduced contribution from Al Yamamah support programme
- Cash flow benefits from programme debt reduction
- Order book growth

	2005	2004 ⁵
Sales ¹	£2,923m	£2,856m
EBITA ²	£419m	£497m
Cash inflow ³	£850m	£1,102m
Number of employees ⁴	14,300	13,800
Order book ¹	£5.0bn	£4.6bn



Key points

- Delivery of Saudi strategy on track
 - Compound construction
 - Saudi joint venture company formed
 - Increasing employment of Saudi nationals
- Government to government Understanding Document signed on Saudi armed forces modernisation
- Delivery of UK partnered support growth strategy
- Improved performance from Australian business

Looking forward

CS&S will continue to work closely with the UK Defence Logistics Organisation to provide smarter, more integrated, support solutions on customer bases. Good progress is being made on the future support model for the UK Tornado aircraft. Opportunities for similar support arrangements exist on other UK platforms.

Looking forward, CS&S will continue to work to sustain a long-term presence in Saudi Arabia, delivering on our commitments on current support contracts and developing new business following the signing of the Understanding Document in December 2005, between the governments of the Kingdom of Saudi Arabia and the UK.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards

Integrated Systems & Partnerships

Integrated Systems & Partnerships is a portfolio of high-technology defence systems businesses comprising the wholly-owned Integrated System Technologies, Underwater Systems, and Atlas Elektronik, together with a 37.5% interest in the pan-European MBDA joint venture, a 20.5% interest in Saab of Sweden and a 50% interest in the Gripen International joint venture.

The Integrated Systems & Partnerships business group generated EBITA² of £109m (2004 £95m) on sales¹ of £1,834m (2004 £2,022m). There was an operating cash inflow³ of £17m (2004 £59m).

A significant restructuring of the Company's portfolio of European defence systems business interests was accomplished in 2005.

The Eurosystems transaction, which was completed in April 2005, restructured the AMS joint venture with the UK based defence systems activities being retained by BAE Systems and with Finmeccanica retaining the Italian based activities.

As part of this transaction the electronic warfare systems and sensor systems activities of the former UK based avionics business group were sold to Finmeccanica.

The Eurosystems transaction realised a net cash inflow of £402m in 2005 with a further £268m receivable subject to a put option

exercisable by BAE Systems in the three month period from the beginning of June 2007 and a call option by Finmeccanica at any time to August 2007.

The Group also reduced its equity interest in Saab from 34.2% to 20.5% generating cash of £125m. In a revision to the earlier joint marketing arrangements for the Gripen combat aircraft, Saab has now assumed responsibility for winning new export business.

Integrated System Technologies

The Integrated System Technologies (Insyte) business was formed in May 2005 from the UK based defence system's activities of the AMS joint venture and existing BAE Systems UK based C4ISR⁶ activities.

Insyte projects include the full-scale engineering development of the Sampson multi-function radar. A revised timetable has been agreed to address maturity in the systems software, currently impacting the Principal Anti-Air Missile System for the Type 45 destroyer programme.

Insyte has been selected for two key UK transformational technology network enabled capability systems, the Falcon communications infrastructure programme and the Shaman communications electronic support measures system for the Royal Navy.

Insyte also secured the order for the Maritime Composite Training System (MCTS)

working as the lead in the SEABRIDGE team, with partners Aerosystems International, EDS, Flagship Training, MDA and Serco. MCTS will provide the Royal Navy with a new shore-based warfare operator training capability that will meet the training needs of the Type 45 destroyer in 2007, and current in-service ships.

The creation of the Insyte business gives BAE Systems a new strength in the integration of high technology systems.

MBDA (37.5%)

2005 saw MBDA's sales increase by 6% to €3.2bn and EBITA² grow by 19%. This performance was driven by significant deliveries of the Storm Shadow and Scalp EG precision strike cruise missile to the French and UK customers in addition to first deliveries to the Italian air force. Significant deliveries of the Mica air-to-air missile to both the French air force and export customers also underpinned the sales performance together with the entry into service of the advanced air-launched anti-armour weapon system, Brimstone, to the Royal Air Force.

MBDA's order book of €12.6bn at 31 December 2005 benefited from the award of the design and development phase of the new Medium Extended range Air Defence System (MEADS), which is a mobile ground-to-air missile defence system to provide protection from future air and missile defence threats. MBDA's share of the MEADS order was €512m. Other orders

in the year included the French contract for the development and production of over 2,000 of the new Mistral RMV air defence missiles for the new FREMM multi-mission frigate programme for which MBDA is the primary combat system partner. Two important export orders, including from India, for the Exocet anti-ship weapon, were also achieved.

MBDA has made good progress on the multi-national Meteor and Aster-PAAMS programmes. Meteor met its key development milestones in the year culminating in flight trials of the missile on the Gripen and Rafale aircraft by the end of December. Key firings were also successfully completed of the Aster 30 missile, an integral part of the PAAMS air defence system for the Royal Navy's new Type 45 destroyers, while the new 180km-range Exocet Block 3 anti-ship weapon commenced qualification.

The acquisition of the German missile company, LFK, was agreed at the end of 2005 and the process to obtain regulatory approval is currently in progress.

Atlas Elektronik

Atlas Elektronik, the Bremen-based naval systems business, had a year of good progress with the completion of trials for the COSYS Malaysia system. Important progress has also been made towards completing the development of the DM2A4 heavyweight torpedo and in successfully concluding the NATO trials for the IMCMS

Maritime Composite Training System (MCTS)

BAE Systems has been awarded a contract to supply the Royal Navy with a new shore-based Warfare Operator Training capability to meet the needs of current in-service surface platforms and the Type 45 Ready for Training later this decade.



mine counter measures system for the Dutch and Belgian navies. Export orders for DM2A4 contributed to good order intake in the year.

On 30 December, an agreement was entered into for the disposal of Atlas Elektronik jointly to ThyssenKrupp and EADS for a cash consideration of approximately €145m. In addition, pension and related liabilities valued at 31 December 2005 of €96m will remain with Atlas following the sale. In 2005, Atlas Elektronik contributed sales of £216m and EBITA² of £10m.

Completion of the sale, which is conditional upon regulatory clearances, is expected to take place in the first half of 2006.

Underwater Systems

The main production order for Sting Ray Mod1, an autonomous electrically-propelled lightweight torpedo, is well underway. The first torpedoes will enter service in 2006. In April 2005, the Company secured an extension to the existing support arrangements for the Spearfish torpedo in a contract worth £58m over three years.

Securing a UK MoD agreement for the upgrade of the Spearfish heavyweight torpedo will be an important feature in determining the future shape of the business.

Saab (20.5%)

2005 has seen a number of important developments in the Saab business. In October, the company's participation in

Neuron, a European Unmanned Combat Air Vehicle demonstrator project was effectively confirmed with the Swedish government announcement of its involvement in the programme.

In the same month, Saab signed a provisional contract to supply airborne surveillance systems to Pakistan, with a value of approximately SEK5.5bn (£400m). Important conditions do remain to be met before the contract becomes effective and order intake should be recognised in 2006.

Saab's financial performance for 2005 was affected by difficulties on a contract for the supply of tactical mission systems for 18 Swedish helicopters.

Gripen International (50%)

Gripen International has been responsible for the design and sale of the export variant of the Gripen new generation, multi-role combat aircraft. The aircraft has been ordered by South African, Hungarian and Czech Republic air forces. The first of the aircraft for South Africa flew in November, ahead of schedule. Deliveries of Gripen combat aircraft to the Czech Republic continued as part of a leasing arrangement, with final aircraft deliveries completed in August 2005. Hungary has also ordered 14 Gripen with deliveries commencing in 2006. Both these countries will be the first Gripen operators within NATO. The UK Empire Test Pilots' School is also operating Gripen as an advanced fast jet training platform for test pilots worldwide.

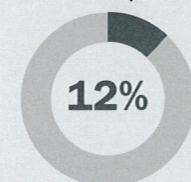
Integrated Systems & Partnerships – Summary

Financial highlights

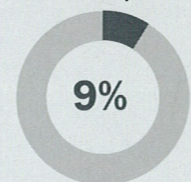
- Financial results reflect portfolio restructuring in the year
- EBITA² improved by 15% over 2004
- Continued good cash flow

	2005	2004 ³
Sales ¹	£1,834m	£2,022m
EBITA ²	£109m	£95m
Cash inflow ³	£17m	£59m
Number of employees ⁴	12,000	13,900
Order book ¹	£5.9bn	£7.0bn

Share of Group sales⁴



Share of Group EBITA²



Key points

- Continued restructuring of European business portfolio – Eurosystems transaction completed
- Integrated System Technologies formed
- Saab stake reduced to 20.5%
- Atlas Elektronik sale agreed
- Revised Gripen International marketing arrangements with Saab

Looking forward

The Integrated Systems & Partnerships businesses are expected to face continued budget pressures in their principal domestic and export markets. The substantial order books and strong positions of the businesses in their respective market sectors are expected to sustain activity over the near term. With a number of development programmes maturing, the MBDA business is expected to progress to a higher proportion of production activity going forward.

Realignment of the business portfolio continues with the completion of the sale of Atlas Elektronik anticipated in the first half of 2006.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards
⁶ Command, Control, Communications and Computing, Intelligence, Surveillance and Reconnaissance

Commercial Aerospace



A380 – the world's largest passenger airliner.

The Commercial Aerospace sector comprises the Company's 20% interest in Airbus together with the Aerostructures business and the regional aircraft asset management and support activities.

In 2005, Commercial Aerospace generated EBITA² of £179m (2004 £201m) on sales¹ of £3,232m (2004 £2,924m). Airbus contributed EBITA² of £273m (2004 £196m) on sales¹ of £3,002m (2004 £2,666m) after charging £227m of development costs (2004 £235m).

The Company's Regional Aircraft business has been impacted by poor lease rates in a weak regional aircraft market and by adjustments to residual value assumptions resulting from airlines operating in the US under Chapter 11 protection. Of the loss for the Regional Aircraft business of £95m in 2005, approximately half arose from airlines moving into Chapter 11.

Airbus generated a strong operating cash inflow³ of £403m. Cash outflow³ at Regional Aircraft was £73m.

Airbus

Airbus is the leading supplier of large commercial jets with 378 aircraft delivered in 2005. Airbus offers a comprehensive range of passenger aircraft from 100 seats to over 555 seats in the new A380 long-range airliner.

In addition to commercial jet airliners Airbus produces freighter aircraft and is developing the A400M military transport aircraft.

Good growth in the global market for large commercial jets above 100 seats has continued through 2005. Orders for more than 2,000 aircraft were placed during the year of which Airbus secured a net 1,055 representing 51% of the market. Growth was driven by a combination of factors. Passenger traffic has continued to recover as confidence returned following the terrorist activity in 2001. The market has also benefited from the rise in low-cost carriers, making air travel affordable and accessible to a wider population. Similarly strong growth is underway and expected to continue in certain regional markets, notably China, India and in the Middle East.

In a drive to maximise value from its large order book Airbus continues to reduce costs. A programme, targeting cost reductions across the Airbus business of approximately £1bn between 2003 and the end of 2006, is on track. Manufacturing and supply agreements are being implemented in growth markets, including China, to support growth and further reduce costs.

Airbus

2005 was a record year for Airbus across the board surpassing previous numbers on deliveries, order intake and profitability. In terms of orders Airbus continued to outsell its competitors for the fifth consecutive year, whilst continuing to lead in terms of deliveries for the third year in a row.



A number of major new product development programmes are presently underway at Airbus.

A380

When it enters service towards the end of 2006 the A380 will be the world's largest passenger airliner. Typically it will be configured with 555 seats on two full-length passenger decks. The first flight of the A380 took place in April 2005 with two further aircraft joining the flight development programme during the year.

A350

The A350 is the latest addition to the Airbus product range. This 250 seat all-new airliner programme was launched in October 2005 and the aircraft is expected to enter service in 2010. The A350 will make use of a number of technical innovations applied to the A380, such as new materials, to deliver significant enhancements to range and fuel consumption over comparable earlier generation aircraft.

A400M

The A400M is an advanced military transport designed with a load capacity of 37 tons and up to 120 personnel. 180 aircraft are being produced for seven participating nations. The first export contract was secured in 2005 with an order for eight aircraft from South Africa. The first flight of the A400M is planned for the end of 2007, with entry into service scheduled for 2009.

Aerostructures

Aerostructures is a supply chain management and assembly business. It has customer relationships with the major aircraft manufacturers providing airframe components and assemblies for commercial aircraft and business jets. Contracts include assemblies for Airbus commercial aircraft. The Aerostructures business produces the leading and trailing edges for the A380 wing as well as wing structures for the Boeing B777 and B767 and major structures for Raytheon's Hawker 800XP business jet. All product lines met customer requirements in 2005.

In August 2005, BAE Systems sold Precision Aerostructures, its US based aircraft component machining and fabrication facility.

In January 2006, the sale of the UK Aerostructures business to Spirit AeroSystems Inc. was announced, for a cash consideration of £80m. Completion is expected to take place in the first half of 2006. In 2005, Aerostructures contributed sales of £223m and EBITA² of £8m.

Regional Aircraft

In 2005, Asset Management, BAE Systems' commercial aircraft leasing team, successfully reached agreements securing over US\$240m of income on over 100 aircraft from its Jet/Turboprop portfolio. These included lease deals with SN Brussels for 23 Regional Jets and Eurowings/Air Dolomiti for 11 BAe 146 aircraft. Additionally, the team successfully facilitated a number of airline credit restructurings, securing ongoing income on portfolio aircraft.

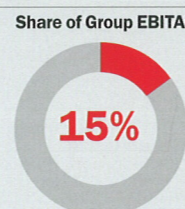
Regional Aircraft derives 80% of its support business from spares and logistics sales. An increasing proportion of this activity is provided under power by the hour contracts that now cover over 50% of the regional jet fleet.

Commercial Aerospace – Summary

Financial highlights

- Sales growth of 11% over 2004 on 378 aircraft deliveries by Airbus
- EBITA² stated after loss of £95m from Regional Aircraft business
- EBITA² contribution from Airbus of £273m
- Cash outflow³ from Regional Aircraft of £73m
- Airbus order book for 2,365 aircraft

	2005	2004 ⁴
Sales ¹	£3,232m	£2,924m
EBITA ²	£179m	£201m
Cash inflow ³	£327m	£226m
Number of employees ¹	12,500	12,600
Order book ¹	£29.5bn	£20.9bn



Key points

- Strong Airbus order intake
- First flight of A380 long-range airliner
- Airbus cost reduction programme on track
- Airbus new product development programmes underway
- Ongoing losses in Regional Aircraft
- Aerostructures disposal announced

Looking forward

The commercial aviation market continues to grow despite the financial fragility of many airlines, exacerbated by high oil prices.

Near-term prospects for Airbus remain good, with a strong order book. Airbus aircraft deliveries are expected to continue to increase, with growth from low cost carriers in the single-aisle market and as airline customers in Asia and the Far East equip with longer-range aircraft.

The regional aircraft market remains difficult and underlying losses in the support business will continue.

¹ including share of equity accounted investments
² earnings before amortisation and impairment of intangible assets, finance costs and taxation expense
³ net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments
⁴ before elimination of intra-group sales
⁵ as restated under International Financial Reporting Standards

Summarised financial review

Results for the year – continuing operations

Sales¹ increased 17% from £13,222m to £15,411m. The growth reflects sales of £789m from the acquired United Defense business together with the benefit of 2004 acquisitions and increased deliveries across the majority of the Group. This was partially offset by the impact of the reduced Saab shareholding.

Return on sales for the Group was maintained at 7.7% (2004 7.7%).

EBITA² increased 16% from £1,016m to £1,182m. EBITA² has been reduced by rationalisation provisions of £89m and is stated after United Defense acquisition accounting adjustments of £44m. Losses at Regional Aircraft amounted to £95m.

Underlying earnings³ per share from continuing operations for 2005 increased by 29.3% to 22.5p compared with 2004.

Basic earnings per share in accordance with IAS 33 Earnings per Share, from continuing operations, increased by 28.9% to 18.3p (2004 14.2p).

The Group manages the performance of its businesses primarily on measures of operating cash flow and underlying earnings³.

Cash inflow from operating activities was £2,099m (2004 £2,350m).

Operating business cash flow was £1,937m (2004 £2,134m). Good conversion of EBITA to operating cash flow was delivered across much of the Group together with the cash benefits of securing advance payments at Land & Armaments and programme debt reduction at Customer Solutions & Support.

Free cash flow, after interest, preference dividends and taxation, was £1,758m (2004 £1,924m).

The net cash outflow on acquisitions and disposals was £1,548m. In addition, net debt acquired on acquisition of subsidiary undertakings was £288m. During the year the Group completed the acquisition of 100% of the issued share capital of United Defense Industries, Inc, in the US, for a total consideration of £2,205m. In addition, the Group completed the Eurosystems disposal transaction resulting in a net cash inflow of £402m. The Eurosystems transaction comprised the sale of a majority holding in BAE Systems Avionics Limited and the whole of the UK communications business, and the dissolution of AMS, the 50/50 joint venture of BAE Systems and Finmeccanica.

Finance costs

Finance costs, including the Group's share of the finance costs of equity accounted investments, were £215m (2004 £176m). The underlying interest charge of £210m (2004 £200m) was increased by a net charge of £5m (2004 net gain £24m) arising from pension accounting, marked-to-market revaluations of financial instruments and foreign currency movements.

The net debt of the Group at 31 December 2005 was £1,277m, an increase of £326m from £951m at the start of the year, after adjusting for IAS 32 and IAS 39. Interest cover based on EBITA² decreased from 5.8 times to 5.5 times.

Taxation

The Group's effective tax rate for the year was 29% (2004 32%).

The tax rate in the 2006 financial year is expected to be in line with 2005.

Dividend

The Board is recommending a final dividend of 6.3p per share (2004 5.8p), bringing the total dividend for the year to 10.3p per share (2004 9.5p), an increase of 8.4%. The proposed dividend is covered 2.2 times by earnings³ from continuing operations (2004 1.8 times).

Exchange rates

The principal exchange rates impacting the Group are as follows:

	2005	2004
£/€ – average	1.462	1.474
£/\$ – average	1.819	1.832
£/€ – year end	1.455	1.417
£/\$ – year end	1.718	1.932

Accounting policies

Detailed guidance on the Group's critical and significant accounting policies can be found in the Annual Report 2005 on our website, www.baesystems.com.

¹ including share of equity accounted investments' sales

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

³ earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and uplift on acquired inventories

Corporate responsibility

Corporate responsibility at BAE Systems

BAE Systems recognises its responsibilities to the people it employs, its customers and suppliers, its shareholders, the wider community and to the environment.

Corporate responsibility (CR) in BAE Systems is about good business practice and continual improvement. We recognise our wide-ranging responsibilities and our CR framework has been developed around key stakeholder interest and feedback, potential risk to our business and the extension, review and improvement of existing practices.

Governance of CR

The board of directors has overall responsibility for governance of CR matters within the Company. Specific responsibility has been assigned to the recently formed Corporate Responsibility Committee. All members of this committee are non-executive directors and comprise Peter Weinberg, Professor Sue Birley, Phil Carroll and Michael Portillo. The committee is responsible for reviewing and monitoring the processes the Company uses to manage social, environmental and ethical risk, as well as assisting the Board in the development of strategy and policy in this area. The committee is supported by the Group Legal Director, Audit Director, Group HR Director and Director of Corporate Responsibility.

The committee met for the first time in 2005 and has agreed several long-term strategic objectives to ensure CR contributes to the sustainability of the Company's performance through ensuring continual improvement of application, communication and evolution of non-financial processes. Further information on these objectives can be found in our full Corporate Responsibility Report.

Performance

In 2005 BAE Systems maintained its leading position in both the Dow Jones Sustainability World Index and the pan European Dow Jones STOXX Sustainability Index. Our total score increased from 68% to 81%, a clear indication of our improved performance in the area of corporate responsibility and sustainability. The score reflects improvements across the three areas of social, economic and environment but the results also highlighted a need to continue to increase transparency on how we manage certain business issues. We are committed to addressing this.



Key issues for our business

It is important that our CR reporting addresses issues that are material to our business and reflect stakeholder concerns. In 2005 we commissioned PricewaterhouseCoopers to provide an independent view of the issues relevant to our CR reporting and an understanding of our CR stakeholders and their key concerns. We will use the findings from this work to focus our CR reporting and drive stakeholder engagement during 2006.

The key areas our stakeholders consider material to our business are anti-bribery and corruption practices, health and safety, government relations and political influence and product responsibility. Additional information on these and other key issues is available in our full Corporate Responsibility Report.

2006 CR objectives

We regularly review and update our CR programmes to ensure we make progress. We set yearly objectives, details of which can be found in our full Corporate Responsibility Report, at both a strategic and operational level. The specific CR objectives agreed for our Chief Executive and his leadership team in 2006 are to:

- resolve 75% of employee grievances in the UK at local level;
- reflect gender diversity on leading university courses in choice of graduate trainees through a focused recruitment plan;
- exceed safety performance commitments made to the UK Health and Safety Executive;
- meet safety, health and environment targets;
- meet standards defined through our internal assurance process; and
- develop, pilot and roll out online ethics training to all employees in the UK and Australia.



Full information and supporting data on all our CR activities can be found in our Corporate Responsibility Report or on our website at www.baesystems.com/corporateresponsibility

Board of directors

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15



Chairman

1. Dick Oliver^{3,4}
Appointed Chairman on 1 July 2004. A civil engineer, Dick Oliver joined BP in 1973 where he held a variety of senior positions culminating in his appointment to the board of BP p.l.c. as CEO of Exploration and Production in 1998. He was subsequently appointed deputy group chief executive of BP in 2003, stepping down from that position when he assumed the chairmanship of BAE Systems. Dick Oliver chairs the Board's Nominations Committee and the Non-Executive Directors' Fees Committee. He is a non-executive director of Reuters Group plc and deputy chairman of TNK-BP and a Fellow of the Royal Academy of Engineering.
Appointed: 2004 Age: 59

Executive directors

2. Mike Turner CBE⁴, Chief Executive
Appointed Chief Executive in 2002, having been a Chief Operating Officer since 1999. He is a member of the shareholder committee of Airbus SAS having formerly been a member of the Airbus Industrie GIE Supervisory Board. He is a non-executive director of The Peninsular and Oriental Steam Navigation Company (P&O) and a former non-executive director of Babcock International Group Plc.
Appointed: 1994 Age: 57

3. Chris Geoghegan, Chief Operating Officer
Appointed to the Board in 2002 as a Chief Operating Officer. He was formerly responsible for the group's Airbus operations and, in 2000, was appointed Group Managing Director of the Avionics business. He is President of the Society of British Aerospace Companies.
Appointed: 2002 Age: 51

4. Michael Lester⁴, Group Legal Director
Appointed a member of the Board following the BAe/MES merger. Prior to the merger he was a director and vice chairman of The General Electric Company, p.l.c. (GEC). He is a non-executive director of Premier Farnell plc.
Appointed: 1999 Age: 65

5. Steve Mogford, Chief Operating Officer
Appointed to the Board in 2000 as a Chief Operating Officer, he has held a number of senior positions within the Group including responsibility for the Group's military aircraft operations. He is chairman of the Eurofighter Supervisory Board.
Appointed: 2000 Age: 49

6. Mark Ronald CBE⁴, Chief Operating Officer
Appointed to the Board in 2002 as a Chief Operating Officer. Formerly head of GEC's North American defence business, in 1999 he was appointed President and CEO of BAE Systems North America (now BAE Systems, Inc.). He is a member of the board of governors of the Electronic Industries Association and the board and executive committee of the Aerospace Industries Association.
Appointed: 2002 Age: 64

7. George Rose, Group Finance Director
Appointed Group Finance Director in 1998, he is a member of the shareholder committee of Airbus SAS. Prior to joining the Company in 1992, he held senior positions in the Rover Group and Leyland DAF. He is a non-executive director of Saab AB and National Grid Transco plc, and a member of the Financial Reporting Review Panel.
Appointed: 1998 Age: 53

Non-executive directors

8. Professor Sue Birley^{2,5}
Formerly Professor of Entrepreneurship at Imperial College, University of London, and has held a number of academic posts at INSEAD, London Business School and Cranfield Institute of Technology. She was formerly a non-executive director of National Westminster Bank plc. Professor Birley chairs the Board's Remuneration Committee.
Appointed: 2000 Age: 62

9. Phil Carroll^{2,3}
Appointed to the Board in 2005, Phil Carroll is a former chairman and chief executive of Fluor Corporation and a former president and chief executive of Shell Oil Company Inc. He was appointed by the US Department of Defense in 2003 to serve as the first Senior Adviser to the Iraqi Ministry of Oil. He is a former non-executive director of Scottish Power plc.
Appointed: 2005 Age: 68

10. Dr Ulrich Cartellieri¹
Ulrich Cartellieri served as a member of the Managing and subsequently the Supervisory Board of Deutsche Bank AG for over 20 years until 2004. Until recently he was also a member

of the International Advisory Committee of the Federal Reserve Bank of New York and is currently a director of Robert Bosch GmbH. He is a former chairman of Karstadt AG and a former deputy chairman of Siemens AG.
Appointed: 1999 Age: 68

11. Michael Hartnall¹
Formerly finance director of Rexam plc, prior to which he held senior positions with a number of manufacturing companies. He is also a non-executive director of Lonmin plc and a former non-executive director of Elementis plc. Michael Hartnall chairs the Board's Audit Committee. He is a Fellow of the Institute of Chartered Accountants in England and Wales.
Appointed: 2003 Age: 63

12. Sir Peter Mason KBE^{1,3}
Chief executive of AMEC plc. Prior to joining AMEC plc in 1996, he served as an executive director of BICC plc, chairman and chief executive of Balfour Beatty Limited and chief executive of Norwest Holst Group PLC. Sir Peter Mason has been nominated the Board's Senior Independent Director.
Appointed: 2003 Age: 59

13. Rt Hon Michael Portillo^{1,2}
A cabinet minister in the 1990s, Michael Portillo was successively Chief Secretary to the Treasury, Secretary of State for Employment, and Secretary of State for Defence. He entered Parliament in 1984 and was admitted to the Privy Council in 1992, stepping down as a Member of Parliament in 2005 to pursue a career in broadcasting and the media.
Appointed: 2002 Age: 52

14. Roberto Quarta^{1,5}
Appointed to the Board in 2005, Roberto Quarta is chairman (and was formerly chief executive) of BBA Group plc and, as a partner of the private equity firm Clayton, Dubilier & Rice, also serves as chairman of Rexel SA and Italtel. He was previously an executive director of BTR plc and a non-executive director of PowerGen plc and Equant NV.
Appointed: 2005 Age: 56

15. Peter Weinberg^{2,5}
Appointed to the Board in 2005, Peter Weinberg was previously chief executive officer of Goldman Sachs International and co-head of the Partnership Committee, and prior to that was co-head of the Global Investment Banking Division. He joined Goldman Sachs in 1988 and became a partner in 1992. Peter Weinberg chairs the Board's Corporate Responsibility Committee.
Appointed: 2005 Age: 48

Each of the eight non-executive directors listed above is considered to be independent for the purposes of the Combined Code on Corporate Governance.

Company Secretary

David Parkes

¹ member of the Audit Committee
² member of the Corporate Responsibility Committee
³ member of the Nominations Committee
⁴ member of the Non-Executive Directors' Fees Committee
⁵ member of the Remuneration Committee

Corporate governance

Combined Code compliance

As required by the UK's Combined Code on Corporate Governance (the 'Combined Code') all companies that have a stock market listing in the UK are required to make disclosures in relation to corporate governance.

The Board has considered the Company's compliance with the provisions of the Combined Code and confirms that in the period since 16 June 2005 to the date of this report it was compliant with all provisions. Prior to this date it believes that it was compliant with all provisions with the exception of provision A.3.2. This provision requires that at least half of the Board, excluding the Chairman, should comprise non-executive directors determined by the Board to be independent.

Summarised remuneration report The Remuneration Committee

The Board has delegated to the Remuneration Committee ('the Committee') responsibility for remuneration policy and determining the specific packages for the Chairman and the executive directors; the Committee also agrees the framework for the remuneration of certain other members of the executive management team. The Committee's terms of reference conform with the requirements of the Combined Code, and can be found on the Company's website or obtained from the Company Secretary.

Remuneration principles

The Committee's remuneration strategy is to provide a remuneration package that:

- helps attract, retain and motivate the highest calibre executives;
- is aligned to shareholders' interests to create sustainable long-term shareholder value;
- is competitive against the appropriate market, providing median reward for median performance and upper quartile reward for upper quartile performance;
- encourages and supports a high performance culture whilst providing a balance between fixed and variable reward; and
- is fair and transparent and can be applied consistently throughout the Group.

Executive remuneration review 2005

The Remuneration Committee undertook a formal review of executive remuneration

policy in 2005 and subsequently undertook a consultation with major shareholders. As a result of this process, the following changes have been made to remuneration policy:

(i) Chief Executive's remuneration

The remuneration review concluded that the remuneration structure for the executive directors remained appropriate and generally in line with the market with the exception of the remuneration of the Chief Executive, whose salary was shown to be below market and for whom the bonus potential and long-term incentives were significantly below market. Given the Chief Executive's time in the role, his performance and the performance of the Group, the Committee agreed the following improvements to the Chief Executive's package for 2006:

- **Base salary:** increased to £870,000 with effect from 1 January 2006;
- **Bonus potential:** increased to 150% of base salary but with one third of his bonus to be compulsorily deferred into the new Share Matching Plan (see below);
- **Long-term incentives:** a 50% increase in the annual awards of share options and performance shares to 225% of base salary in share options and 150% of base salary in performance shares. These increases in annual awards will give a total combined expected value of long-term incentives (including the new Share Matching Plan) of around 150% of base salary.

These enhancements will position the Chief Executive's overall reward package in line with the market median.

(ii) Executive Share Schemes

Subject to formal shareholder approval in May 2006, the Restricted Share Plan (referred to on page 31) will be replaced by a Share Matching Plan (SMP) and will have performance conditions attached to the vesting of matching shares. The current Performance Share Plan (PSP) will be replaced by a similar PSP, also subject to formal shareholder approval in May 2006. Further details of the new SMP and PSP are included in the AGM Notice of Meeting accompanying this Review.

(iii) UK executive pension arrangements

In a separate exercise from the remuneration review, the Committee has concluded its review of UK executive pension arrangements in view of the

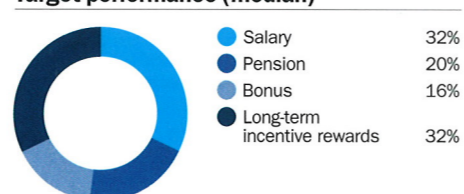
new tax rules which come into effect from April 2006. These new tax rules introduce the concept of a 'Lifetime Allowance', i.e. the maximum amount of pension savings that can benefit from tax relief. The Company will not compensate individuals, including directors, for the tax changes; instead it will offer choices that are broadly cost neutral to the Company but which may better suit the needs of the individuals affected.

Remuneration policy

The Committee's executive remuneration policy continues to be to set basic salaries at median competitive levels whilst seeking to reward upper quartile performance with potential upper quartile remuneration through the use of bonus schemes and share-based incentives. The Committee intends to continue with the executive remuneration policy as detailed in this report in 2006 and subsequent years, and will continue to consult on material changes with principal shareholders.

Remuneration of executive directors consists typically of basic salary, a bonus based on annual performance, participation in employee share schemes and retirement benefits. The Committee reviews the split between basic salary and the performance related elements of remuneration each year in order to incentivise properly executive directors, and believes that a significant proportion of remuneration should be based on schemes that encourage them to perform at the highest level. Through this arrangement, it is possible for those individuals who contribute to sustained high levels of company performance to receive at least a similar level of reward from variable compensation to that received from fixed compensation. At median performance, variable remuneration represents approximately 50% of the remuneration package as shown in the chart below:

Target performance (median)



The package of the Chief Executive is more highly geared with almost 60% of the remuneration being performance related.

At upper quartile performance variable remuneration represents significantly more than 50% of the total package.

Basic salary

Executive directors' salaries are reviewed each year by the Committee and adjusted to reflect performance and the competitiveness of salaries relative to the market. Information on the market for comparable management positions is obtained from independent sources and is provided to the Committee so that it can form a view as to where to position basic salaries and benefits relative to comparable companies.

The methodology used is to construct appropriate comparator groups for the individual positions taking account of company size, scale of operations and breadth of role. As there is no readily available market data for the Group Legal Director, the Committee has used the data for the other executive director roles as a guide to position his package. The median and upper quartile positions are then analysed for base salary, total cash reward (base salary plus annual bonus), total direct reward (total cash reward plus long-term incentives) and total reward including pension. This gives the Committee a view on the competitiveness of the individual elements as well as the package as a whole. The Committee also reviews the trends in the elements of remuneration to ensure that the structure of the package stays in line with market practice, and also takes account of the performance of the individual, the Company as a whole and the pay and conditions of group employees.

Annual bonus plan

The executive directors and other senior executives participate in a cash bonus scheme that rewards those individuals if pre-determined targets are met. The targets are derived from the Integrated Business Plan (IBP), which is agreed by the Board and which implements corporate strategy on a group-wide basis by ensuring that business plans which support the strategy are integrated across all businesses. The IBP is used to set the objectives for senior management including the base and stretch targets for the financial measures used for the executive directors in the Annual Bonus Plan. Non-financial targets comprise key objectives relevant to the individual and/or business

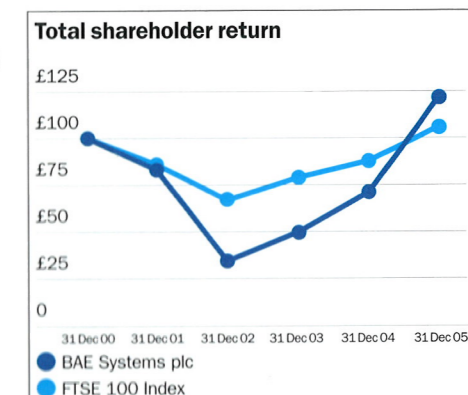
and also take account of behavioural performance. The maximum bonus potential for 2006 remains the same as for 2005 at 100% of salary (150% for the US based executive director, Mark Ronald) with the exception of the maximum bonus potential for the Chief Executive which has increased to 150% of base salary with at least one-third of his bonus being compulsorily deferred into the new Share Matching Plan.

Share option schemes and long-term incentive schemes

Through the use of share-based incentive schemes the Committee seeks to align the interests of the executive directors with those of other shareholders. The Company operates a combination of option and share-based awards for executive directors within the following framework which is in line with similar plans operated by other FTSE 100 companies:

- Options granted under the Executive Share Option Plan are to be set at a maximum of 1.5 x base salary (2.25 x base salary for the Chief Executive). Vesting of options is subject to the achievement of real earnings per share (EPS) growth targets over a three-year performance period. There will be no retesting after the three year performance period for options to be granted in 2006.
- Awards under the Performance Share Plan are to be set at 1 x base salary (1.5 x base salary for the Chief Executive). The median level of vesting for the 2006 awards will be 25% of the shares under award if the Company's total shareholder return (TSR) performance (share price growth plus dividends) over a three-year performance period is in the top 50% of the TSR comparator group, with 100% of the shares under award being released if the TSR is in the top 20%. Intermediate positions will be calculated on a straight line pro-rata basis. Vesting will also be subject to the Committee being satisfied there has been a sustained improvement in underlying financial performance. The TSR comparator group comprises 18 other major defence and aerospace companies operating internationally.

In determining the performance criteria, the Committee took the view that EPS is a key indicator of long-term financial performance and value creation and that TSR is an indication of earnings and capital growth relative to the industry-specific comparator group.



This graph shows the value, by 31 December 2005, of £100 invested in BAE Systems on 31 December 2000 compared with the value of £100 invested in the FTSE 100 Index. The other points plotted are the values at intervening financial year ends.

The graph, which has been produced in accordance with the requirements of Schedule 7A to the Companies Act 1985, shows the total shareholder return for a holding in the Company's ordinary shares for the period 2000-2005 relative to a holding of shares representing the FTSE 100. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity market index. As BAE Systems is a constituent member of the FTSE 100, it was deemed to be the most appropriate general UK equity index.

Executive directors who participate in the Annual Bonus Plan may be given the option of taking any net cash bonus paid partly or wholly in shares through the Restricted Share Plan (RSP) for which a matching award of shares is made after three years providing the individual normally remains in the Company's employment at the vesting date. The matching award is not subject to performance criteria as the RSP was designed to retain key staff and encourage them to invest the cash bonuses they have earned under the bonus plan which was itself based on performance criteria. The RSP will operate in 2006 but will be replaced by the new SMP (referred to on page 30) in 2007 and will have performance conditions attached to the matching shares.

The UK based executive directors are also entitled to participate in the Company's Share Incentive Plan, an all-employee share plan.

Post-retirement benefits

The executive directors of the Company are members of group pension schemes and pay contributions at the same rate as all other employees participating in the

Corporate governance continued

schemes (except where they have already reached normal retirement age).

The Company has been in consultation with the UK employee representatives and National Trade Union Officials to address its UK pension scheme deficits. Proposals are being put to the trustees of the Main UK Pension Scheme following the support shown by a recent Trade Union Consultative ballot and a survey carried out by the Company on measures to be taken in respect of the Main Pension Scheme. These measures include changes to benefits in respect of future service accrual. All changes, which at the date of this Review remain subject to approval by the trustees of the Main Pension Scheme, will apply to the pension arrangements of the UK based executive directors who are active members of that scheme. Consultations with employee representatives and National Trade Union Officials are continuing in respect of the resolution of deficit issues in relation to the other UK pension schemes.

Executive directors' service contracts

It is the Remuneration Committee's policy that executive directors should normally have service contracts that provide for the Company to give the individual 12 months' notice of termination. This policy has been chosen because it provides a reasonable balance between the need to retain the services of key individuals and the need to limit the liabilities of the Company in the event of the termination of a contract. Mark Ronald, who has a one-year rolling contract, is entitled inter alia to compensation of a lump sum equal to one year's salary if his contract is not renewed at the end of its term.

Chairman

Dick Olver was appointed Chairman on 1 July 2004. He is required to devote at least two days a week to his duties as Chairman, unless his appointment is terminated earlier in accordance with the Company's Articles of Association, or by either party giving to the other not less than six months' prior written notice.

Non-executive directors

Fees payable to the non-executive directors are agreed by the Non-Executive Directors' Fees Committee.

Directors' remuneration

	2005					2004
	Basic salary £'000	Fees £'000	Bonus £'000	Benefits £'000	Total £'000	Total £'000
Chairman						
R L Olver	-	500	-	5	505	257
Executive directors						
C V Geoghegan ¹	445	-	423	25	893	842
M Lester	540	-	529	31	1,100	1,030
S L Mogford ¹	445	-	441	24	910	850
M H Ronald ^{1,2}	495	-	744	32	1,271	1,096
G W Rose ^{1,2}	500	-	495	27	1,022	928
M J Turner ¹	800	-	792	46	1,638	1,486
Non-executive directors						
Prof S Birley	-	63	-	-	63	55
P J Carroll*	-	18	-	-	18	n/a
Dr U Cartellieri	-	53	-	-	53	45
M J Hartnall	-	73	-	-	73	65
Sir Peter Mason	-	63	-	-	63	55
Rt Hon M Portillo	-	53	-	-	53	45
R Quarta*	-	18	-	-	18	n/a
P A Weinberg*	-	34	-	-	34	n/a
Past directors						
Sir Richard Evans**	n/a	n/a	n/a	n/a	n/a	208
Lord Hesketh***	-	16	-	-	16	45
P Scaroni**	n/a	n/a	n/a	n/a	n/a	7
	3,225	891	3,424	190	7,730	7,014

* appointed during the year

** retired as a director in 2004

*** retired as a director in 2005

¹ accruing retirement benefits under defined benefit schemes at 31 December 2005

² accruing benefits under money purchase arrangements at 31 December 2005

All emoluments and compensation paid to directors during the year are shown in the table. Where the individual was appointed during the year the amount shown is for the period from appointment.

The aggregate amount of unrealised gains made by directors on share options was £85,110 and the aggregate net value of assets received by directors from long-term incentive plans was £155,058. The aggregate amount of company contributions paid in respect of money purchase retirement benefits for directors was £572,382 being (i) a payment of £3,004 to Mark Ronald's 401(k) plan; and (ii) a payment of £569,378 to George Rose's FURBS arrangement (comprising a normal contribution of approximately £377,328, plus a payment of approximately £192,000 to deal with investment under-performance prior to 2003).

As a result of the detailed salary review undertaken by the Remuneration Committee, the base salary of the executive directors has increased with effect from 1 January 2006 to the following: Chris Geoghegan: £467,500; Michael Lester: £567,500; Steve Mogford: £467,500; Mark Ronald: \$1,000,000; George Rose: £530,000; and Mike Turner: £870,000. (Mark Ronald's base salary was increased from \$850,000 to \$950,000 with effect from 1 July 2005 following the acquisition of United Defense and its subsequent integration into the Land & Armaments business group).

Within the 2005 Annual Bonus Plan for executive directors, all the financial targets were met at the stretch level. In addition, excellent progress was made against all the key non-financial objectives although more work still needs to be done in securing technology transfer from the US to the UK. Accordingly, bonus payments for 2005 as set out in the table above range from 95% to 99% of the maximum bonus.

The Non-Executive Directors' Fees Committee has agreed the following fee structure for the non-executive directors in 2006: Chairman of the Audit Committee: £70,000; Chairmen of the Remuneration Committee and the Corporate Responsibility Committee, and the Senior Independent Director: £65,000; and each of the other non-executive directors: £50,000. In addition a transatlantic meeting allowance of £4,000 per meeting is paid to European based non-executive directors attending board meetings in the US and to US based non-executive directors attending meetings in Europe.

Non-executive directors are paid a fee reflecting the time commitment required of the director. The fee level for the chairmen of the individual committees and the Senior Independent Director reflects their additional responsibilities and workload. Fees payable to non-

executives in 2005 and 2006 are set out in the table above.

The Chairman and non-executive directors do not have service contracts but do have a letter of appointment detailing the basis of their appointment.

Consolidated income statement

for the year ended 31 December

	2005 £m	Total 2005 £m	2004 £m	Total 2004 £m
Continuing operations				
Combined sales of Group and equity accounted investments		15,411		13,222
Less: share of equity accounted investments		(4,392)		(4,405)
Revenue		11,019		8,817
Operating costs		(10,579)		(8,369)
Other income		247		110
<i>Group operating profit excluding amortisation and impairment of intangible assets</i>	809		668	
<i>Amortisation</i>	(77)		(13)	
<i>Impairment</i>	(45)		(97)	
Group operating profit		687		558
<i>Share of results of equity accounted investments excluding finance costs and taxation expense</i>	373		348	
<i>Finance costs</i>	(11)		(27)	
<i>Taxation expense</i>	(149)		(105)	
Share of results of equity accounted investments		213		216
<i>Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA)</i>	1,182		1,016	
<i>Amortisation</i>	(77)		(13)	
<i>Impairment</i>	(45)		(97)	
<i>Finance costs of equity accounted investments</i>	(11)		(27)	
<i>Taxation expense of equity accounted investments</i>	(149)		(105)	
Operating profit		900		774
Finance costs				
Financial income	1,224		609	
Financial expense	(1,428)		(758)	
		(204)		(149)
Profit before taxation		696		625
Taxation expense				
UK taxation	(37)		(58)	
Overseas taxation	(76)		(110)	
		(113)		(168)
Profit for the year from continuing operations		583		457
Loss for the year from discontinued operations		(28)		(454)
Profit for the year		555		3
Attributable to:				
BAE Systems shareholders		553		2
Minority interests		2		1
		555		3
Earnings per share				
Continuing operations:				
Basic earnings per share		18.3p		14.2p
Diluted earnings per share		18.2p		14.2p
Discontinued operations:				
Basic loss per share		(0.9)p		(14.8)p
Diluted loss per share		(0.8)p		(14.8)p
Total:				
Basic earnings/(loss) per share		17.4p		(0.6)p
Diluted earnings/(loss) per share		17.4p		(0.6)p

Consolidated balance sheet

as at 31 December

	2005 £m	2004 £m
Non-current assets		
Intangible assets	8,217	6,115
Property, plant and equipment	1,704	1,746
Investment property	218	155
Equity accounted investments	1,721	1,469
Other investments	9	66
Other receivables	912	511
Other financial assets	65	-
Deferred tax assets	1,331	1,090
	14,177	11,152
Current assets		
Inventories	485	498
Trade and other receivables including amounts due from customers for contract work	1,877	2,198
Current tax	20	-
Other investments	634	763
Other financial assets	54	-
Cash and cash equivalents	2,581	1,651
	5,651	5,110
Non-current assets and disposal groups held for sale	407	-
	6,058	5,110
Total assets	20,235	16,262
Non-current liabilities		
Loans	(3,534)	(2,113)
Trade and other payables	(432)	(464)
Retirement benefit obligations	(4,101)	(3,210)
Other financial liabilities	(45)	-
Deferred tax liabilities	(23)	(14)
Provisions	(375)	(241)
	(8,510)	(6,042)
Current liabilities		
Loans and overdrafts	(905)	(951)
Trade and other payables	(7,006)	(6,154)
Other financial liabilities	(81)	-
Current tax	(316)	(200)
Provisions	(343)	(250)
	(8,651)	(7,555)
Liabilities directly associated with non-current assets and disposal groups held for sale	(270)	-
	(8,921)	(7,555)
Total liabilities	(17,431)	(13,597)
Net assets	2,804	2,665
Capital and reserves		
Issued share capital	80	143
Share premium	782	412
Equity option of convertible preference shares	78	-
Other reserves	4,720	5,323
Retained earnings	(2,872)	(3,223)
Total equity attributable to equity holders of the parent¹	2,788	2,655
Minority interests	16	10
Total equity¹	2,804	2,665

¹ 2004 includes £266m non-equity shareholders' funds

Approved by the Board on 22 February 2006 and signed on its behalf by:
M J Turner
Chief Executive

G W Rose
Group Finance Director

Consolidated cash flow statement

for the year ended 31 December

	2005 £m	2004 £m
Profit/(loss) for the year	583	457
Continuing operations	(28)	(454)
Discontinued operations	555	3
Taxation expense (includes £1m (2004 £7m) from discontinued operations)	114	175
Share of results of equity accounted investments	(213)	(216)
Net finance costs (includes £3m (2004 £nil) from discontinued operations)	207	149
Depreciation, amortisation and impairment	524	861
(Gain)/loss on disposal of property, plant and equipment	2	12
(Gain)/loss on disposal of investment property	(43)	(40)
(Gain)/loss on disposal of business – continuing operations	12	-
(Gain)/loss on disposal of business – discontinued operations	8	-
Impairment of other investments	2	5
Cost of equity-settled employee share schemes	16	8
Movements in provisions	99	46
Increase in liabilities for retirement benefit obligations	(98)	(7)
(Increase)/decrease in working capital:		
Inventories	54	(58)
Trade and other receivables	(4)	703
Trade and other payables	864	709
Cash inflow from operating activities	2,099	2,350
Interest paid	(213)	(197)
Interest element of finance lease rental payments	(17)	(27)
Taxation paid	(27)	(31)
Net cash inflow from operating activities	1,842	2,095
Dividends received from equity accounted investments	88	69
Interest received	99	66
Purchases of property, plant and equipment	(318)	(343)
Capital expenditure on investment property	(12)	-
Purchases of intangible assets	(17)	(23)
Proceeds from sale of property, plant and equipment	30	81
Proceeds from sale of investment property	54	50
Proceeds from sale of non-current investments	30	-
Purchase of non-current other investments	(17)	(50)
Purchase of subsidiary undertakings	(2,262)	(663)
Net cash acquired with subsidiary undertakings	128	113
Proceeds from sale of subsidiary undertakings	460	-
Cash and cash equivalents disposed of with subsidiary undertakings	1	-
Proceeds from sale of equity accounted investments	125	-
Net proceeds from sale/(purchase) of other deposits/securities	45	(51)
Net cash outflow from investing activities	(1,566)	(751)
Capital element of finance lease rental payments	(89)	(141)
Proceeds from issue of share capital	373	-
Equity dividends paid	(315)	(281)
Dividends paid on preference shares	(21)	(21)
Cash inflow from loans	1,005	-
Cash outflow from repayment of loans	(357)	(219)
Net cash inflow/(outflow) from financing activities	596	(662)
Net increase in cash and cash equivalents	872	682
Cash and cash equivalents at 1 January	1,650	970
Effect of foreign exchange rate changes on cash and cash equivalents	(31)	(2)
Cash and cash equivalents at 31 December	2,491	1,650
Cash and cash equivalents	2,581	1,651
Overdrafts	(90)	(1)
Cash and cash equivalents at 31 December	2,491	1,650

Consolidated statement of recognised income and expense

for the year ended 31 December

	2005 £m	2004 £m
Currency translation on foreign currency net investments:		
Subsidiaries	53	(56)
Equity accounted investments	(23)	(59)
Change in fair value of Exchange Property	-	13
Adjustment to interest in net assets of Saab AB	-	2
Amounts charged to hedging reserve	(688)	-
Actuarial losses on defined benefit pension schemes:		
Subsidiaries	(652)	(803)
Equity accounted investments	(72)	(146)
Current tax on items taken directly to equity	(3)	-
Deferred tax on items taken directly to equity:		
Subsidiaries	193	281
Equity accounted investments	276	35
Net income recognised directly in equity	(916)	(733)
Profit for the year	555	3
Total recognised income and expense	(361)	(730)
Adoption of IAS 32 and IAS 39	422	-
	61	(730)
Attributable to:		
Equity shareholders	(363)	(730)
Minority interest	2	-
	(361)	(730)

Auditors' statement

Statement of the independent auditors to the members of BAE Systems plc pursuant to section 251 of the Companies Act 1985

We have examined the summary financial statements set out on pages 33 to 36.

This statement is made solely to the Company's members, as a body, in accordance with section 251 of the Companies Act 1985. Our work has been undertaken so that we might state to the Company's members those matters we are required to state to them in such a statement 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 work, for this statement, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors are responsible for preparing the Annual Review in accordance with applicable United Kingdom law. Our responsibility is to report to you our opinion on the consistency of the summary financial statements within the Annual Review with the full annual financial statements, and the directors' remuneration report, and its compliance with the relevant requirements of section 251 of the Companies Act 1985 and the regulations made thereunder.

We also read the other information contained in the Annual Review and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the summary financial statements.

Basis of opinion

We conducted our work in accordance with Bulletin 1999/6 'The auditor's statement on the summary financial statements issued by the Auditing Practices Board for use in the United Kingdom. Our report on the Group's full annual financial statements describes the basis of our audit opinion on those financial statements.

Opinion

In our opinion the summary financial statements are consistent with the full annual financial statements and the directors' remuneration report of BAE Systems plc for the year ended 31 December 2005 and comply with the applicable requirements of section 251 of the Companies Act 1985 and the regulations made thereunder.

KPMG Audit Plc

Chartered Accountants
London
Registered Auditor

22 February 2006

Shareholder information

Registered office

6 Carlton Gardens
London
SW1Y 5AD
United Kingdom
Telephone: +44 (0)1252 373232
Company website: www.baesystems.com

Registered in England & Wales,
No. 1470151

Registrars

Lloyds TSB Registrars (0140)
The Causeway, Worthing
West Sussex BN99 6DA
United Kingdom
Telephone: 0870 600 3982
(+44 121 415 7058 from outside the UK)

If you have any queries regarding your shareholding, please contact the registrars.



Shareview service

The Shareview service from our registrar, Lloyds TSB Registrars, gives shareholders:

- direct access to data held on their behalf on the share register including recent share movements and dividend details;
- the ability to change their address or dividend payment instructions on-line.

To sign up for Shareview you need the 'shareholder reference' printed on your proxy form or dividend stationery. There is no charge to register. When you register with the site, you can register your preferred format (post or e-mail) for shareholder communications. If you select 'e-mail' as your mailing preference, you will be sent shareholder communications, such as proxy forms and annual/interim results by e-mail instead of post, as long as this option is available.

If you have your dividends paid straight to your bank account, and you have selected 'e-mail' as your mailing preference, you can also collect your tax voucher electronically. Instead of receiving the paper tax voucher, you will be notified by e-mail with details of how to download your electronic version. However, if you choose 'post' as your preference, you will be sent paper documents as usual.

Visit the website for more details:
www.shareview.co.uk

Details of software and equipment requirements are given on the website.

Shareholder dealing service

Hoare Govett Limited offers a low cost postal dealing service enabling UK resident shareholders to buy or sell BAE Systems plc shares. Basic commission is 1%, subject to a minimum charge of £15.00. If you require further information please contact:

Hoare Govett Limited
Telephone: +44 (0)20 7678 8300

This notice has been approved by Hoare Govett Limited which is authorised and regulated by the Financial Services Authority.

ShareGift

The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at www.sharegift.org or by telephone on 020 7337 0501.

Share price information

The middle market price of the Company's ordinary shares on 31 December 2005 was 381.75p, the range during the year was 224.5p to 388p.

Daily share prices are available in the UK on the FT Cityline service as follows:

BAE Systems plc ordinary shares
Telephone: 0906 003 1890
BAE Systems plc preference shares
Telephone: 0906 003 5174

(Calls are charged at 60p per minute at all times)

Alternatively you can view teletext or a similar service.

Dividend reinvestment plan

The company offers holders of its ordinary shares the option to elect to have their dividend reinvested in shares purchased in the market instead of cash. If you would like to make this election, please request a dividend reinvestment plan mandate from our registrars:

Lloyds TSB Registrars
The Causeway, Worthing
West Sussex BN99 6DA
Telephone: 0870 241 3018
Telephone number from outside the UK:
+44 121 415 7058

American Depositary Receipts

The BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares. JPMorgan Chase Bank, N.A. is the depository.

If you should have any queries, please contact:
JPMorgan Chase Bank, N.A.
JPMorgan Service Center
PO Box 3408
South Hackensack NJ 07606-3408
USA
Toll free telephone number: 800 990 1135
Telephone number from outside the US:
+1 201 680 6630

Website: www.adr.com
Email: adr@jpmorgan.com

Financial calendar

Financial year end	31 December
Annual General Meeting	4 May 2006
Preference shares conversion date	31 May 2006
2005 final ordinary dividend payable	1 June 2006
2006 half yearly preference dividend payable	3 July 2006
2006 interim results announcement	September 2006
2006 interim ordinary dividend payable	November 2006
2006 half yearly preference dividend payable	2 January 2007
2006 full year results – preliminary announcement	February 2007
– report and accounts	April 2007
2006 final ordinary dividend payable	June 2007

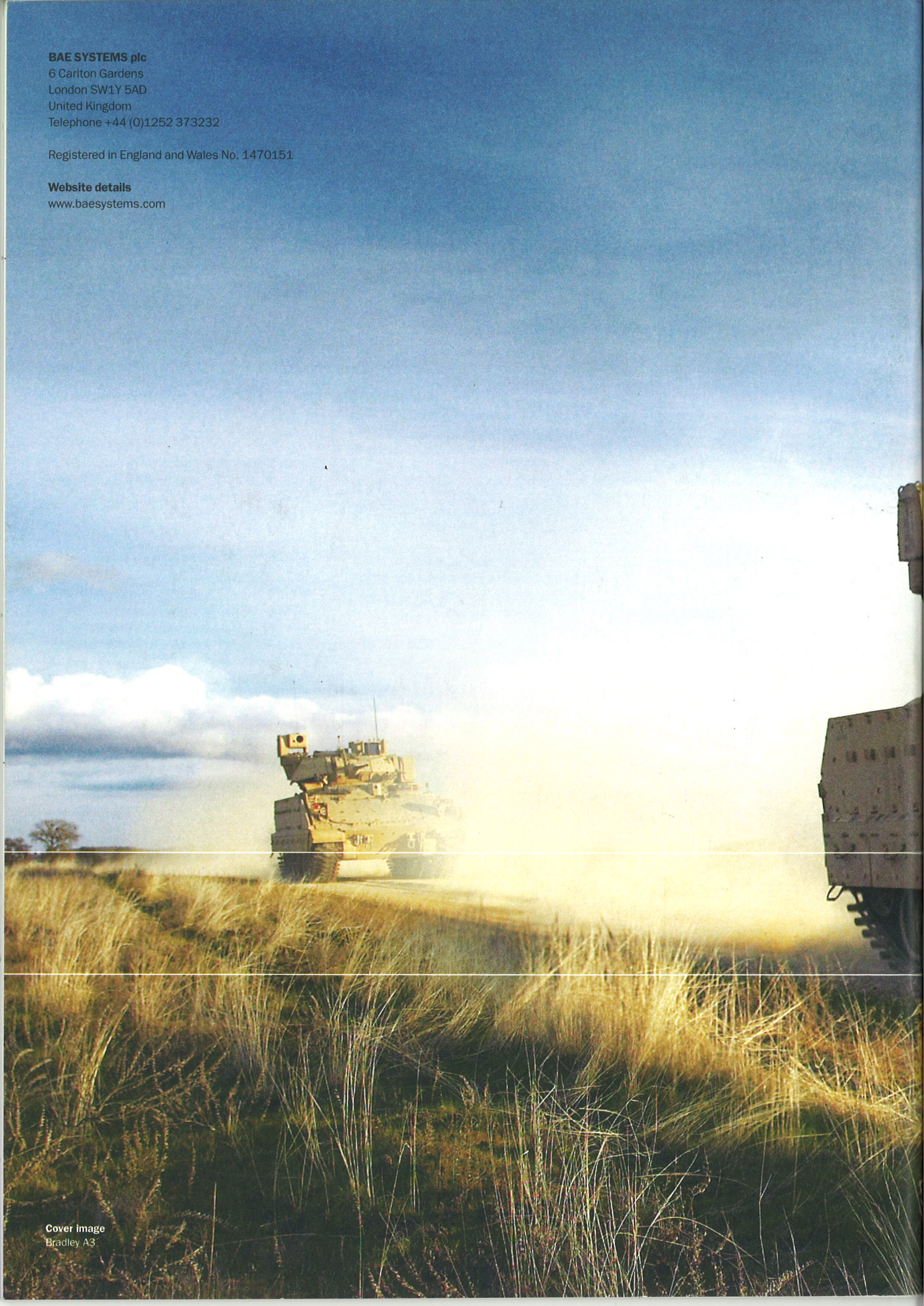
BAE SYSTEMS plc

6 Carlton Gardens
London SW1Y 5AD
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Registered in England and Wales No. 1470151

Website details

www.baesystems.com



Cover image
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