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**BT Group plc
ANNUAL REPORT & FORM 20-F
2011**



*official communications
services partner of the
Olympic and Paralympic Games*

FINANCIAL REVIEW

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INTRODUCTION FROM THE GROUP FINANCE DIRECTOR



Tony Chanmugam
Group Finance Director

How we performed in 2011

2011 performance against our financial outlook

In May 2010 we set out our financial objectives for the three-year period to 2013. We said we expected to improve our revenue trends and to grow EBITDA and free cash flow, while investing in the business, reducing net debt, supporting the pension fund and paying progressive dividends.

In 2011 we have made good progress towards achieving these objectives and have delivered full year results in line with or ahead of our outlook for the year. Market conditions remain challenging, with the UK telecoms market being one of the most competitive in the world. However, we have delivered some significant milestones in 2011 and have exited the year in the right place to continue to deliver against our financial objectives over the next two years.

Revenue trends

Revenue declined by 4% to just over £20bn in 2011. Excluding foreign exchange movements and the reduction in low-margin transit revenue which includes the impact of mobile termination rate reductions, underlying revenue excluding transit was down 3% in 2011.

Growing EBITDA and earnings per share

The execution of our cost transformation programmes have helped deliver over £1bn of operating cost reductions in 2011, ahead of our outlook for the year. Overall, adjusted EBITDA grew by 4% to £5,886m in 2011, also ahead of our outlook for the year.

Higher operating profit and lower finance expense increased adjusted earnings per share by 21% to 21.0p in 2011.

Growing free cash flow

We generated adjusted free cash flow of £2.2bn in 2011, well ahead of our initial outlook of around £1.8bn for the year. This

reflects our improved profitability and working capital performance and is after investing £2.6bn in capital expenditure. BT Global Services achieved their operating cash flow positive milestone a year ahead of expectations.

Investing in the business

The savings we have made in operating costs and working capital improvements have enabled us to invest in the future of our business both in terms of capital and operating expenditure. Our fibre roll-out is one of the most rapid in the world and we are on track to pass 5m premises by spring 2011. We have significantly increased the number of customers enjoying next generation broadband services and have invested in reducing the number of faults in our network and getting things 'right first time' for our customers.

Reducing net debt and supporting the pension fund

Net debt has reduced by £467m to £8,816m, in line with our outlook to be below £9bn by 31 March 2011. This is after making pension deficit payments of £1,030m, including £505m brought forward from December 2011. We also repaid maturing debt of £2.5bn from our existing cash and investment balances and agreed a new five-year £1.5bn committed facility. There are no further significant debt maturities until 2013. The IAS 19 net pension position has significantly reduced by £4.3bn to a deficit of £1.4bn, net of tax, at 31 March 2011.

Progressive dividends

As we stated in 2010, the Board is committed to paying progressive dividends, whilst balancing the need to invest in the business, reduce our net debt and support the pension fund. Taking these considerations into account, the Board is proposing a full year dividend of 7.4p, up 7%.

Outlook

We expect underlying revenue excluding transit to grow in 2013. Adjusted EBITDA is expected to show further growth in 2012 and to be above £6.0bn in 2013. We expect adjusted free cash flow to be above the 2011 level in 2012 and 2013, with BT Global Services generating operating cash flow of around £200m in 2012.

Tony Chanmugam
Group Finance Director

11 May 2011

How we performed in 2011

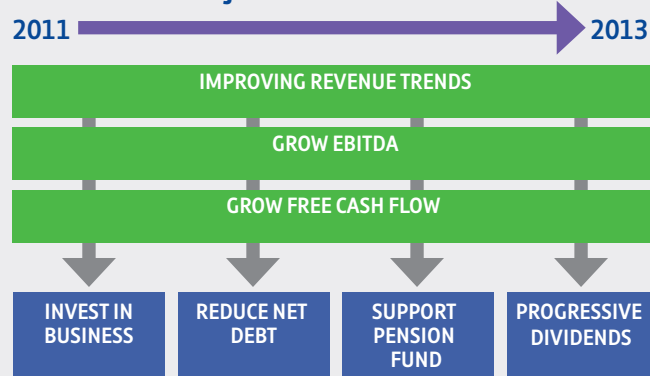
	Outlook May 2010	Result	
Revenue	c.£20bn	£20.1bn	✓
Operating cost savings	c.£900m	£1.1bn	✓
Adjusted EBITDA ^a	in line with 2010 ^b	£5.9bn	✓
Adjusted free cash flow ^{a,c}	c.£1.8bn ^b	£2.2bn	✓
Net debt ^a	<£9bn	£8.8bn	✓

^a Adjusted EBITDA, adjusted free cash flow and net debt are non-GAAP measures. See pages 56 to 58 for details.

^b Adjusted EBITDA and adjusted free cash flow outlook updated in November 2010 to be around £5.8bn and £2bn.

^c Before pension deficit payments.

Our financial objectives



FINANCIAL PERFORMANCE

Summarised income statement

	Year ended 31 March 2011		
	Before specific items £m	Specific items £m	Total £m
Revenue	20,076	–	20,076
Other operating income	373	–	373
Operating costs excluding depreciation and amortisation	(14,563)	(329)	(14,892)
EBITDA	5,886	(329)	5,557
Depreciation and amortisation	(2,979)	–	(2,979)
Operating profit	2,907	(329)	2,578
Net finance expense	(845)	(79)	(924)
Share of post tax profits of associates and joint ventures	21	–	21
Profit (loss) on disposal of interest in associate	–	42	42
Profit (loss) before taxation	2,083	(366)	1,717
Taxation (expense) credit	(452)	239	(213)
Profit (loss) for the year	1,631	(127)	1,504

Group results

In this Financial review we discuss the financial results of the group for 2011, 2010 and 2009. We explain financial performance using a variety of measures. In particular, in this **Financial review**, we principally discuss the group's results on an 'adjusted' basis being before specific items. The rationale for using adjusted measures is explained on page 56. A definition of specific items is set out on page 56. Specific items for 2011, 2010 and 2009 are disclosed in note 8 to the consolidated financial statements and summarised on pages 56 to 57 of this **Financial review**. In 2011 net interest on pensions has been included in specific items because of its volatile nature, and also the BT Global Services contract and financial review charges in 2009 by virtue of their size and nature. Accordingly, specific items for comparative periods have been represented to reflect this reclassification.

We also explain financial performance using measures that are not defined under IFRS and are therefore termed non-GAAP measures. The non-GAAP measures we use in this **Financial review** are adjusted and reported EBITDA, adjusted and reported free cash flow and net debt. Each of these measures is discussed in more detail on pages 56 to 58.

In this **Financial review**, references to '2011', '2010' and '2009' are to the financial years ended 31 March 2011, 2010 and 2009, respectively. References to 'the year' and 'the current year' are to the year ended 31 March 2011.

Outlook

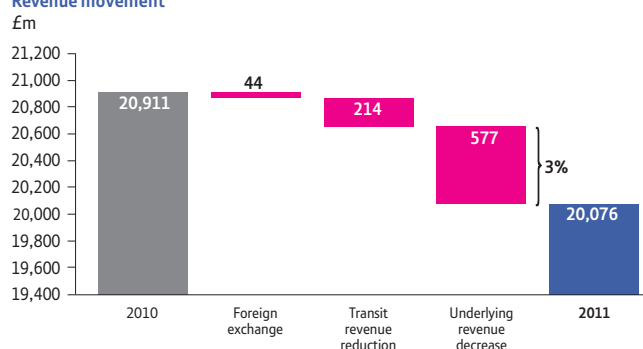
We are focusing on long-term profitable revenue growth. Underlying revenue excludes the impact of foreign exchange movements, acquisitions and disposals and specific items. As transit traffic is low-margin and significantly impacted by regulatory reductions in mobile termination rates, with no impact on the group's profitability, we have excluded transit from our key measure of the underlying revenue performance of the group. Transit revenue declined by £214m in 2011, and we expect it to decline by around a further £400m in 2012 and £200m in 2013, largely due to mobile termination rate reductions. Underlying revenue, excluding transit was down 3% in 2011 and we expect it to be in the range down 2% to flat in 2012 and to grow by up to 2% in 2013.

Adjusted EBITDA is expected to show further growth in 2012 and to be above £6.0bn in 2013. We expect adjusted free cash flow to be above the 2011 level in 2012 and 2013, with BT Global Services generating operating cash flow of around £200m in 2012.

Revenue

In 2011 revenue decreased by 4% (2010: 2% decrease). Excluding the negative impact of foreign exchange movements and the reduction in low-margin transit revenue, underlying revenue excluding transit was down 3%.

Revenue movement



Products and services revenue

Our products and services include telecommunications services provided in the UK and also a wide range of products and services provided globally. These are designed to meet the demand for IT infrastructure and solutions and satisfy the expansion of broadband.

Year ended 31 March 2010			Year ended 31 March 2009		
Before specific items £m	Specific items £m	Total £m	Before specific items £m	Specific items £m	Total £m
20,911	(52)	20,859	21,431	(41)	21,390
378	2	380	352	(13)	339
(15,650)	(427)	(16,077)	(16,545)	(1,993)	(18,538)
5,639	(477)	5,162	5,238	(2,047)	3,191
(3,039)	–	(3,039)	(2,890)	–	(2,890)
2,600	(477)	2,123	2,348	(2,047)	301
(890)	(268)	(1,158)	(933)	313	(620)
25	29	54	39	36	75
–	(12)	(12)	–	–	–
1,735	(728)	1,007	1,454	(1,698)	(244)
(398)	420	22	(361)	414	53
1,337	(308)	1,029	1,093	(1,284)	(191)

Our products and services are sold separately or as part of solutions whereby they work together as a unified offering. An analysis of revenue by major product and service category is set out below:

	2011 £m	2010 £m	2009 £m
Products and services			
ICT and managed networks	6,632	6,574	6,382
Broadband and convergence	2,767	2,677	2,618
Calls and lines	5,595	6,225	6,799
Transit	1,518	1,758	2,003
Conveyance, interconnect circuits, WLR, global carrier and other wholesale	1,471	1,451	1,506
Other products and services	2,093	2,226	2,123
Revenue	20,076	20,911	21,431

Descriptions of products and services provided by individual lines of business is included in **Our lines of business** on pages 23 to 35.

ICT and managed networks

In 2011 ICT and managed networks revenue increased by 1% (2010: 3% increase). This growth was mainly due to a continuation of the trends from 2010 with an increase in MNS revenue in BT Wholesale and growth in networked IT services revenue in BT Global Services.

Broadband and convergence

In 2011 broadband and convergence revenue increased by 3% (2010: 2% increase) due to the continued growth in broadband revenue in BT Retail and the increase in LLU revenue in Openreach. This was offset by a decline in broadband revenue in BT Wholesale, reflecting the trend of CPs continuing to switch to LLU provided by Openreach and due to BT Wholesale securing volumes under long term MNS contracts.

Calls and lines

In 2011 calls and lines revenue decreased by 10% (2010: 8% decrease). The continuing decline reflects the challenging market conditions, particularly in the business sector, and the migration from fixed-line calls to broadband, data and IP services.

Transit

In 2011 transit revenue decreased by 14% (2010: 12%). The decrease in both years is due to the impact of regulatory mobile termination rate reductions and the continued decline in low margin transit volumes.

Conveyance, interconnect circuits, WLR, global carrier and other wholesale products

In 2011 revenue from conveyance, interconnect circuits, WLR, global carrier and other wholesale products was broadly flat (2010: 4% decrease).

Other products and services

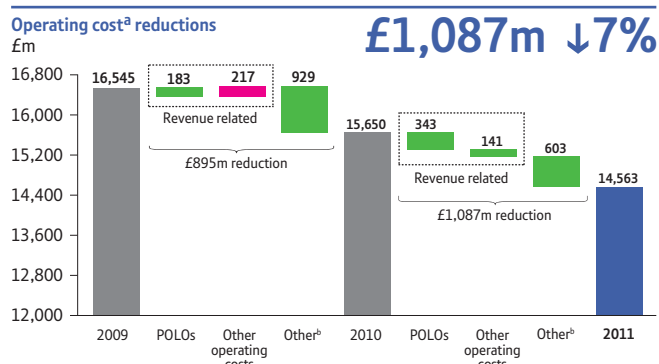
Other products and services revenue principally comprises BT Global Services revenue from non UK global products and revenue from BT Retail's Enterprises division including BT Conferencing, BT Directories and BT Redcare & Payphones. In 2011 revenue from other products and services decreased by 6% (2010: 5% decrease).

Other operating income

Other operating income was £373m in 2011, broadly flat compared with 2010 (2010: 7% increase). The increase in 2010 was principally due to an increase in the profit on sales of scrap and cable recoveries due to increased copper market prices and supplier settlements.

Transforming our cost base

In 2011 we have continued our programme of cost transformation and delivered cost savings of £1,087m, a 7% reduction (2010: 5% reduction). The key drivers of this reduction have been vendor negotiations and price reductions and the transformation and re-engineering of our business activities, delivering improvements in the efficiency and effectiveness across the group.



Operating costs

Operating costs before specific items are shown below:

Year ended 31 March	2011 £m	2010 £m	2009 £m
Staff costs			
Wages and salaries	3,947	4,182	4,499
Social security costs	456	447	432
Pension costs	416	304	544
Share-based payments	68	71	141
Total staff costs	4,887	5,004	5,616
Own work capitalised	(718)	(575)	(673)
Net staff costs	4,169	4,429	4,943
Indirect labour costs	629	722	1,114
Net labour costs	4,798	5,151	6,057
Payments to telecommunications operators	3,740	4,083	4,266
Property and energy costs	1,149	1,284	1,292
Network maintenance and IT costs	706	781	742
Other operating costs	2,786	2,927	2,710
General and administrative costs	1,384	1,424	1,478
Operating costs before depreciation and amortisation	14,563	15,650	16,545
Depreciation	2,288	2,304	2,249
Amortisation	691	735	641
Operating costs	17,542	18,689	19,435

Staff costs

Wages and salaries decreased by 6% to £3,947m (2010: 7% decrease), largely due to the impact of labour resource reductions and efficiencies and lower leaver costs, partly offset by pay inflation and increased overtime. Leaver costs, included within wages and salaries, were £57m (2010: £142m, 2009: £204m).

The pension charge for 2011 was £416m, compared with £304m in 2010 and £544m in 2009. The increase in the pension cost in 2011 reflects the lower discount rate and higher inflation assumptions at the start of the year. The decrease in the pension cost in 2010 reflects the impact of the changes to benefit accruals in BTPS with effect from 1 April 2009, partly offset by an increase in social security costs as BTPS ceased to contract out of the State Second Pension.

Share-based payment costs remained broadly flat at £68m (2010: £71m) in 2011. In 2010 share-based payment costs decreased by 50% reflecting the significant forfeiture cost associated with the high number of the Sharesave cancellations which took place in 2009.

Indirect labour costs

Indirect labour costs decreased by 13% to £629m (2010: 35% decrease) as the group continued to reduce agency and contractor resource and redeploy existing permanent staff to protect jobs where possible.

Payments to telecommunications operators

Payments to telecommunications operators decreased by 8% to £3,740m (2010: 4% decrease). The decrease in 2011 and 2010 reflects the impact of mobile termination rate reductions and lower volumes, with the decrease in 2010 partly offset by unfavourable foreign exchange movements.

Property and energy costs

Property and energy costs decreased by 11% to £1,149m (2010: 1% decrease) mainly reflecting efficiency savings and lower energy prices.

Network maintenance and IT costs

Network maintenance and IT costs decreased by 10% to £706m (2010: 5% increase). The decrease in 2011 is mainly due to vendor savings and lower volumes as a result of lower revenue, whilst the increase in 2010 was mainly due to higher volumes, partly offset by vendor and efficiency savings.

Other operating costs

Other operating costs decreased by 5% to £2,786m (2010: 8% increase). This reduction is mainly due to lower revenue related costs as well as efficiency and vendor savings. The 2010 increase was largely due to unfavourable foreign exchange movements and the impact of acquisitions.

General and administrative costs

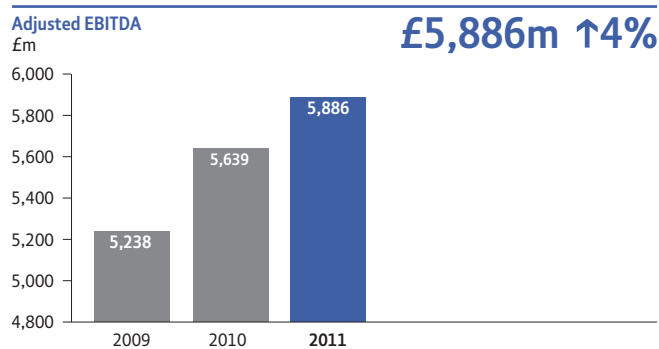
General and administrative costs decreased by 3% to £1,384m (2010: 4% decrease). The decrease in 2011 and 2010 reflects tight control of discretionary expenditure, lower consultancy costs, bad debts and foreign exchange.

Depreciation and amortisation

Depreciation and amortisation decreased by 2% to £2,979m (2010: 5% increase), reflecting lower levels of capital expenditure over the last two years, partly offset by increased expenditure on shorter lived assets.

Adjusted EBITDA

In 2011 adjusted EBITDA was £5,886m, an increase of 4% (2010: 8%). The increase in 2011 and 2010 reflects the benefits of the group-wide cost transformation activities and the improvement in the performance of BT Global Services.



Adjusted EBITDA for the last five financial years is included in **Selected financial data** on page 159.

Operating profit

In 2011 adjusted operating profit was £2,907m, an increase of 12% (2010: 11%) reflecting the improved EBITDA and lower depreciation and amortisation. Reported operating profit was £2,578m in 2011, compared with £2,123m in 2010 and £301m in 2009.

Net finance expense

Net finance expense before specific items, (principally comprising net pension interest) is shown below. Net pension interest is discussed in note 23 to the consolidated financial statements.

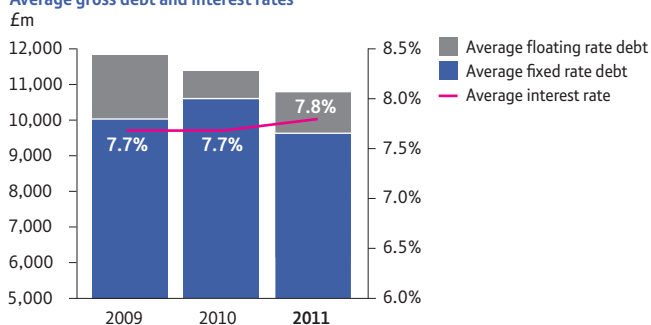
	2011 £m	2010 £m	2009 £m
Interest on borrowings	852	886	935
Fair value movements on derivatives	34	19	29
Finance expense	886	905	964
Less: capitalised interest	(6)	(3)	–
Total finance expense	880	902	964
Interest income	(35)	(12)	(31)
Total finance income	(35)	(12)	(31)
Net finance expense	845	890	933

Finance expense

Interest on borrowings in 2011 was £852m, a decrease of 4% (2010: 5%) reflecting reductions in net debt and the repayment of higher coupon debt in the year. In 2011 the fair value movement on derivatives of £34m (2010: £19m) includes £28m (2010: £9m) of swap restructuring costs on certain derivatives and £6m (2010: £10m) of fair value movements on derivatives not in a designated hedge relationship.

The graph below shows the relationship between average gross debt and interest rates over the three-year period.

Average gross debt and interest rates



Finance income

Interest income arising from listed investments and other interest and similar income was £35m in 2011, an increase of £23m (2010: £12m, a decrease of £19m). The increase in 2011 includes £19m of interest in respect of a tax refund. Excluding the refund, interest in 2011 was £4m higher than in 2010 as a result of higher cash balances in anticipation of funding the debt maturities in the second half of the financial year. The reduction in 2010 was principally due to lower market interest rates on deposits held.

Associates and joint ventures

Our share of the post tax profit from associates and joint ventures was £21m in 2011 (2010: £25m, 2009: £39m). Our most significant associate is Tech Mahindra, which contributed £22m of post tax profits in 2011 (2010: £25m, 2009: £33m). The decrease in 2011 is primarily due to the disposal of a 6.5% interest in Tech Mahindra in 2011, taking our holding to 23.5%.

Profit before taxation

Adjusted profit before taxation was £2,083m in 2011, an increase of 20% (2010: 19% increase). The increase in 2011 and 2010 reflects the improvement in the group's operating profit and the reduction in net finance expense.

Reported profit before taxation was £1,717m in 2011, compared with a profit before taxation of £1,007m in 2010 and a loss before taxation of £244m in 2009.

Taxation

The tax charge for 2011 was £213m and comprised a tax charge of £452m on the profit before taxation and specific items of £2,083m, and a credit of £239m on specific items. The effective rate on the profit before taxation and specific items was 21.7% compared with the statutory rate of 28%, reflecting the utilisation of tax losses and the continued focus on tax efficiency within the group.

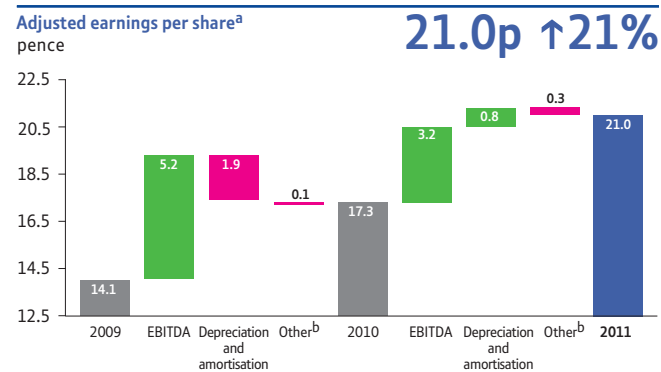
The tax credit for 2010 was £22m (2009: £53m) and comprised a tax charge of £398m (2009: £361m) on the profit before taxation and specific items of £1,735m (2009: £1,454m) and a credit of £420m (2009: £414m) on specific items. The effective rate on the profit before taxation and specific items was 22.9% (2009: 24.8%) compared with the statutory rate of 28%, reflecting the utilisation of tax losses and the continued focus on tax efficiency within the group.

For further details on taxation, see **Taxation** on page 51.

Adjusted earnings per share

Adjusted earnings per share is one of the group's key performance indicators, as detailed in **Our strategy – Key performance indicators** on page 6. It is an important measure of the overall profitability of our business.

Adjusted earnings per share was 21.0p in 2011, an increase of 21% (2010: 23% increase). The graph below shows the drivers of adjusted earnings per share growth over the last two years.



^a Adjusted earnings per share is stated before specific items. See page 57 for further details.

^b Other includes interest, tax and share of post tax profits of associates and joint ventures.

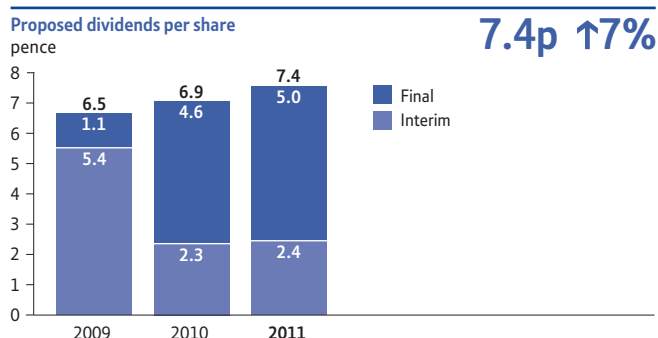
Adjusted earnings (loss) per share for last five financial years are included in **Selected financial data** on page 158.

Dividends

The Board is committed to progressive dividends, while balancing the need to invest in the business, reduce our net debt and support the pension fund.

The total dividend proposed for 2011 is 7.4p per share, an increase of 7% (2010: 6%) and totalling £574m (2010: £534m, 2009: £503m).

The final dividend proposed is 5.0p per share, an increase of 9%, amounting to approximately £388m (2010: £356m, 2009: £85m). This will be paid, subject to shareholder approval, on 5 September 2011 to shareholders on the register on 12 August 2011.



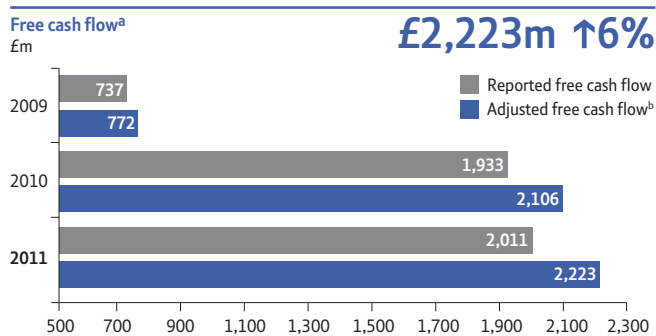
A table setting out the interim, final and total cash dividends paid, or in the case of the final dividend for 2011, proposed, for the last five financial years is included in **Information for shareholders** on page 164.

LIQUIDITY

Free cash flow

The major sources of the group's liquidity for 2011, 2010 and 2009 were the cash generated from the group's operations and borrowing through short-term and long-term issuances in the capital markets. These, as well as committed bank facilities, are expected to remain the key sources of liquidity for the foreseeable future.

In 2011 adjusted free cash flow was £2,223m, nearly trebling compared with £772m in 2009. Adjusted free cash flow is defined on page 58.



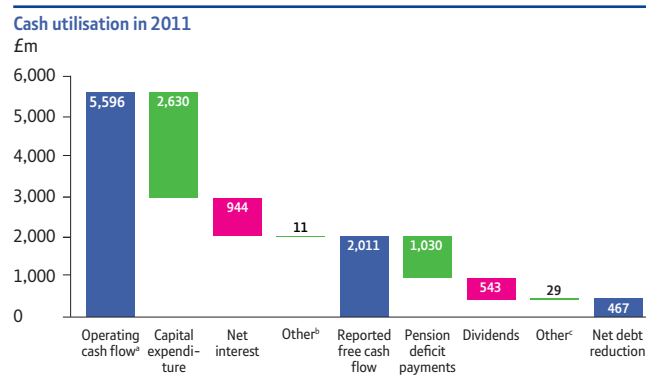
^a Before pension deficit payments.

^b Before specific items.

Reported free cash flow is one of the group's key performance indicators as detailed in **Our strategy – Key performance indicators** on page 6. It is an important measure by which our financial performance is measured, as it represents the cash we generate

from operations after capital expenditure and financing costs. It reflects the cash available to invest in the business, repay debt, support the pension scheme and pay dividends.

The graph below shows how we have used the cash generated from our business in 2011.



^a Net cash inflow from operating activities before pension deficit payments of £1,030m.

^b Other includes purchase of non-current asset investments and dividends from associates and joint ventures.

^c Other mainly includes foreign exchange movements.

A reconciliation from net cash inflow from operating activities, the most directly comparable IFRS measure, to reported free cash flow and adjusted free cash flow is provided on page 58. Reported free cash flow for the last five financial years is included in **Selected financial data** on page 159.

Summarised cash flow statement

	2011 £m	2010 £m	2009 £m
Cash generated from operations	4,775	4,476	4,934
Net income taxes (paid) received	(209)	349	(228)
Net cash inflow from operating activities	4,566	4,825	4,706
Pension deficit payments	1,030	525	–
Net capital expenditure	(2,630)	(2,480)	(3,038)
Purchase of non-current asset investments	(18)	–	–
Dividends from associates and joint ventures	7	3	6
Interest paid	(973)	(956)	(956)
Interest received	29	16	19
Reported free cash flow	2,011	1,933	737
Pension deficit payments	(1,030)	(525)	–
Acquisitions and disposals	64	(68)	(227)
Net sale (purchase) of current financial assets	365	(246)	286
Net (repayment) receipt of borrowings	(1,991)	(497)	522
Dividends paid	(543)	(265)	(1,222)
Net issue (purchase) of treasury shares	8	4	(209)
Foreign exchange	(3)	(7)	54
Net (decrease) increase in cash and cash equivalents	(1,119)	329	(59)
Cash and cash equivalents at the start of the year	1,444	1,115	1,174
Cash and cash equivalents at the end of the year	325	1,444	1,115

Cash flow

Cash generated from operations

In 2011 cash generated from operations was £4,775m, an increase of 7%. This reflects improvements in profitability and working capital, offset by pension deficit payments of £1,030m (2010: £525m, 2009: £nil) which included the early payment of the £525m deficit payment due in December 2011. The level of working capital improvement is not expected to be repeated in 2012.

Net income taxes (paid) received

In 2011 the group paid tax of £209m. In 2010 the group received a net tax repayment of £349m. This comprised tax payments of £76m offset by a tax repayment of £215m, following the agreement of substantially all outstanding tax matters with HMRC, and a repayment of £210m in respect of overpaid corporation tax made in 2009. In 2009 the group paid tax of £228m. For further details see **Taxation** below.

Net capital expenditure

In 2011 net cash outflow on capital expenditure was £2,630m (2010: £2,480m, 2009: £3,038m) which comprised a cash outflow of £2,645m (2010: £2,509m, 2009: £3,082m) offset by cash proceeds from disposals of £15m (2010: £29m, 2009: £44m). Further details on capital expenditure are provided on page 55.

Interest

Interest paid in 2011 was £973m, compared with £956m in 2010, an increase of £17m primarily reflecting higher interest on bonds with step-up coupons, following a downgrade by Standard & Poor's (S&P) in February 2010.

Interest received in 2011 was £29m, compared with £16m in 2010. Excluding interest on tax refunds in both years, interest received was £5m higher in 2011 as a result of higher cash balances in anticipation of funding the debt maturities in the second half of the financial year.

Acquisitions and disposals

There were no significant acquisitions in 2011 or 2010. In 2009, the net cash outflow principally comprised the acquisitions of Wire One Holdings Inc, Ufindus Ltd, Ribbit Corporation and Moorhouse Consulting Ltd.

In 2011 the group disposed of a 6.5% interest in its associate Tech Mahindra for cash proceeds of £67m.

Net sale (purchase) of current and non-current financial assets

The cash flows in each financial year relate principally to changes in the amounts held in liquidity funds on a short-term liquidity management basis.

Net (repayment) receipt of borrowings

During 2011 borrowings amounting to £2,509m matured, principally consisting of bonds of £2,500m which were funded through existing cash and investments. This was partly offset by £340m from bank loans. In 2010 the group raised a €600m Euro bond at 6.125% repayable in 2014 which was swapped into £520m at a fixed semi-annual rate of 6.8%. In 2009 the group raised debt of £795m mainly through its European Medium Term Note programme and received £606m from the net issue of commercial paper. This was partially offset by the repayment of maturing borrowings and lease liabilities amounting to £879m.

Net purchase of shares

In 2011 9m shares were issued out of treasury to satisfy obligations under employee share schemes and executive share awards, receiving consideration of £8m (2010: £4m, 2009: £125m).

There were no purchases of shares in 2011 and 2010. In 2009 143m shares were repurchased for cash consideration of £334m.

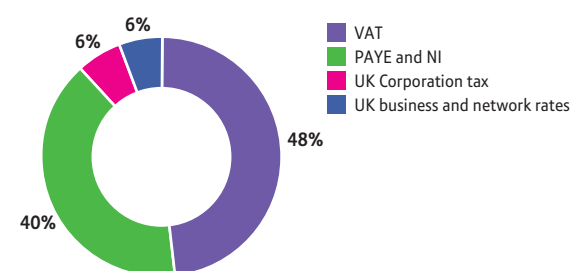
Taxation

Total tax contribution

BT is a significant contributor to the UK Exchequer, collecting and paying taxes of around £3bn in a typical year. In 2011 we collected and paid £1,392m of VAT, £1,146m of PAYE and National Insurance, £175m of UK corporation tax for the current year and £176m of UK business and UK network rates.

Our total UK Exchequer tax contribution as measured in the Hundred Group Total Tax Contribution Survey for 2010 ranked BT the 5th highest contributor.

2011 Total tax contribution



Tax strategy

Our strategy is to comply with relevant regulations whilst minimising the tax burden for BT and our customers. We seek to achieve this through engagement with our stakeholders including HMRC and other tax authorities, partners and customers.

The Board considers that it has a responsibility to minimise the tax burden for the group and its customers. In this respect the Board considers it entirely proper that BT endeavours to structure its affairs in a tax efficient manner where there is strong commercial merit, especially in support of customer initiatives, with the aim of supporting our capital or operational expenditure programmes and reducing our overall cost of capital. This planning is carried out within Board defined parameters. The Board regularly reviews the group's tax strategy.

We operate in over 170 countries and this comes with additional complexities in the taxation arena.

The majority of tax issues arise in the UK with a small number of issues arising in our overseas jurisdictions. In terms of the group's UK corporation tax position, all years up to 2008 are agreed. The UK corporation tax returns for 2010 were all filed prior to the statutory deadline.

We have an open, honest and positive working relationship with HMRC. We are committed to prompt disclosure and transparency in all tax matters with HMRC. We recognise that there will be areas of differing legal interpretations between ourselves and tax authorities and where this occurs we will engage in proactive discussion to bring matters to as rapid a conclusion as possible.

We have a policy to lobby the UK Government directly on tax matters that are likely to impact our customers or shareholders and to respond to consultation documents where the impact could be substantial. We also lobby the UK Government indirectly through the CBI, various working groups and committees and leading professional advisors.

Tax accounting and cash flow

At each financial year end an estimate of the tax charge is calculated for the group and the level of provisioning across the group is reviewed in detail. As it can take a number of years to obtain closure in respect of some items contained within the corporation tax returns it is necessary for us to reflect the risk that final tax settlements will be at amounts in excess of our submitted corporation tax computations. The level of provisioning involves management judgement and estimation.

The UK Government reduced the rate of corporation tax by 2% to 26%, effective from 1 April 2011. This has resulted in a deferred tax credit of £172m in the income statement which has been classified as a specific item. The UK Government has also indicated that it intends to enact future reductions in the corporation tax rate at 1% per annum down to 23% by 1 April 2014.

The tax expense and the cash tax paid in each financial year are different, principally because UK cash tax payments are paid in quarterly instalments which straddle two consecutive financial years. For example, the cash tax paid in 2011 comprised the first two quarterly instalments in respect of 2011 and the last two instalments in respect of 2010. In addition there are differences in the basis of some items, such as pension deficit payments, which are deductible for the purpose of cash tax payments but are not a charge to the income statement and therefore do not impact the tax expense.

The total tax expense for 2011 was £213m and cash tax payments were £209m. Whilst the net difference is insignificant, there are some significant differences. These include the £172m deferred tax credit recognised in the income statement as described above and the current tax deduction available on our pension deficit payments of £1,030m.

The total tax credit for 2010 was £22m and a net tax refund of £349m was received which comprised payments of £76m offset by tax repayments of £425m relating to prior years. The total tax credit in 2009 was £53m and cash tax payments were £229m, of which £210m was repaid in 2010.

Tax losses

The group has unrecognised tax losses of £23.5bn, of which £17.8bn are capital losses arising in the UK, as set out in note 24 to the consolidated financial statements.

FUNDING AND CAPITAL MANAGEMENT

Capital management and funding policy

The objective of the group's capital management policy is to reduce net debt over time whilst investing in the business, supporting the pension scheme and paying progressive dividends. In order to meet this objective the group may issue or repay debt, issue new shares, repurchase shares or adjust the amount of dividends paid to shareholders. The group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the group. The Board regularly reviews the capital structure. No changes were made to the group's objectives and processes during 2011 and 2010.

The general funding policy is to raise and invest funds centrally to meet anticipated requirements using a combination of capital market bond issuance, commercial paper borrowing, committed borrowing facilities and investments. These financial instruments vary in their maturity in order to meet short, medium and long-term requirements.

At 31 March 2011 the group had financial assets of £3.7bn (2010: £6.5bn) consisting of current and non-current investments, derivative financial assets, trade and other receivables, cash and cash equivalents. The reduction in 2011 principally reflects the use of cash and investments to fund £2.5bn of debt maturities.

Credit exposures are continually reviewed and proactive steps are taken to ensure that the impact of adverse market conditions on these financial assets is minimised. In particular, line of business management actively review exposures arising from trading balances and, in managing investments and derivative financial instruments, the treasury operation monitors the credit quality across treasury counterparties and is actively managing exposures which arise.

Additional disclosures relating to financial assets and financial liabilities are included in notes 15, 16, 19, 20, 21, 22, 25 and 29 to the consolidated financial statements and include a debt maturity profile, currency and interest rate composition and hedging strategy. Details of the group's treasury management policies are included in note 29 to the consolidated financial statements.

Net debt

At 31 March 2011 net debt was £8,816m compared with £9,283m at 31 March 2010, a reduction of £467m. Apart from funding the dividend payments of £543m and pension deficit payments of £1,030m the free cash flow generated from business activities has been used to reduce net debt.

The movement in the group's net debt position in 2011 was as follows:

Movements in net debt					
£m	At 1 April 2010	Cash flow	Foreign exchange and fair value movements	Other movements	At 31 March 2011
Bank overdrafts	8	18	–	–	26
Debt due within 1 year	3,261	(2,331)	(491)	20	459
Debt due after 1 year	9,522	340	(511)	20	9,371
Cash at bank and in hand	(197)	53	3	–	(141)
Cash equivalents	(1,255)	1,045	–	–	(210)
Current asset investments	(406)	365	33	(11)	(19)
	10,933	(510)	(966)	29	9,486
Adjustments ^a	(1,650)	–	980	–	(670)
Net debt	9,283	(510)	14	29	8,816

^a Adjustments to net debt of £670m at 31 March 2011 (2010: £1,650m) comprise £408m (2010: £1,326m) arising from the re-translation of currency denominated balances at swapped rates where hedged and £262m (2010: £324m) to remove fair value adjustments and accrued interest.

The group had two significant term debt maturities during 2011 totalling £2.5bn. In December 2010 an 8.125% (9.37% including step-up coupons) US Dollar bond matured with a principal of \$2,883m (£1,742m after including associated currency swaps) and in February 2011 a 6.875% (7.87% including step-up coupons) Euro bond matured with a principal of €1,125m (£758m after including associated currency swaps). The £2.5bn of maturing debt was funded from surplus cash and investments held in anticipation of this requirement. The group has no significant debt maturities until 2013. The maturity profile of the group's term debt is shown in the table below.

Borrowing facilities

In March 2011 the group extended and reduced the level of committed facilities to provide cost efficient medium-term funding security with a five-year £1.5bn committed facility. This facility replaced the £1.5bn facility maturing in January 2013 and the £650m facility maturing in May 2012.

Pensions

Funding valuation and future funding obligations

The funding of the group's main defined benefit pension plan, the BTPS, is subject to a legal agreement between BT and the Trustee determined at the conclusion of each triennial funding valuation. The most recent triennial funding valuation at 31 December 2008

and associated recovery plan was agreed with the Trustee in February 2010.

Under this prudent funding valuation basis, at 31 December 2008 the assets of the BTPS had a market value of £31.2bn and a funding deficit of £9.0bn. If the valuation had used a 'median estimate' approach, we estimate that the deficit would have been about £3bn at December 2008. This approach reflects how investments might on average be expected to perform over time and the expected impact of the pensions review changes implemented on 1 April 2009.

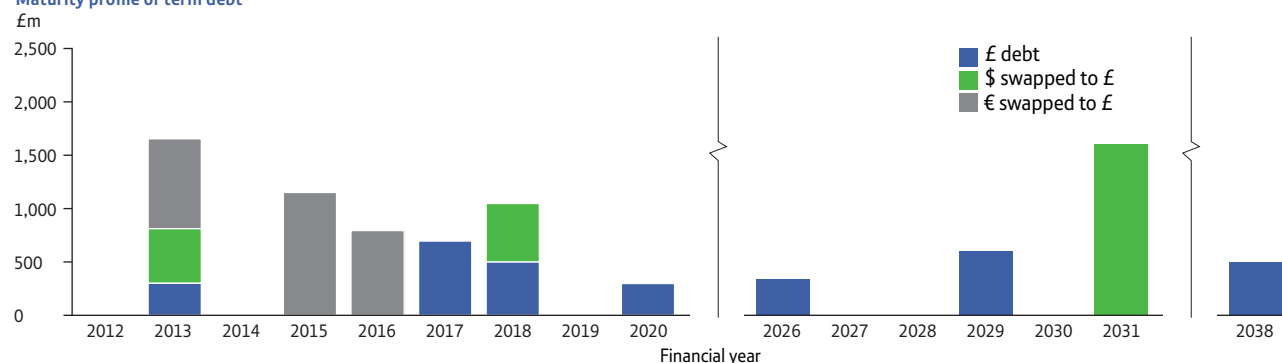
Since the valuation date the scheme's assets have increased by £5.8bn and the liabilities have reduced as a result of the UK Government's announcement regarding future indexation of pension benefits. The Trustee's initial estimate is that if the funding valuation was performed at 31 December 2010, the deficit would have been around £3.2bn on this prudent valuation basis, after the deficit payments of £1,030m in 2011. On a 'median estimate' basis, we estimate that there is a surplus of £3.2bn at 31 March 2011. The next funding valuation is due to be carried out as at 31 December 2011.

Following the agreement of the valuation, the ordinary contributions rate reduced from 19.5% to 13.6% reflecting the changes to member benefits implemented with effect from 1 April 2009. In addition, the group agreed to make deficit payments of £525m per annum for the first three years of a 17-year recovery plan, the first two of which were made in December 2009 and 2010. In March 2011, the group paid £505m representing the actuarial value of the £525m payment due to have been made in December 2011. The payment in December 2012 will be £583m, then increasing at 3% per annum. The payments in years four to 17 are equivalent to £533m per annum in real terms, assuming annual inflation of 3%.

The Pensions Regulator's review of the 2008 BTPS funding valuation and recovery plan is now on hold and is not expected to recommence until the outcome of final Court decision, including any potential appeals, is known on the Crown Guarantee. We do not expect this to be before the completion of the next triennial funding valuation as at 31 December 2011. As is usual, BT and the Trustee will engage with the Pensions Regulator regarding 2011 valuation.

The BTPS was closed to new entrants on 31 March 2001 and people joining BT after that date can participate in a defined contribution pension arrangement. Total membership of the BTPS at 31 March 2011 was 327,500. The number of retired members has been increasing in recent years. Consequently, our future pension costs and contributions will principally depend on the investment returns, mortality of members and inflation, all of which could fluctuate in the medium to long-term.

Maturity profile of term debt^a



^a Balances reported at swapped rates where hedged.

Further details of the BTPS, funding arrangements, triennial valuation and the IAS 19 accounting valuations are provided in note 23 to the consolidated financial statements together with the key demographic and financial assumptions used in the valuations.

Contractual obligations and commitments

A summary of the group's principal contractual financial obligations and commitments at 31 March 2011 is shown below. Further details on the items can be found in the notes to the consolidated financial statements. Details of the group's capital commitments and contingent liabilities are included in note 30 to the consolidated financial statements.

At 31 March 2011 the group had cash, cash equivalents and current asset investments of £370m. The group also had an unused committed borrowing facility amounting to £1.5bn. These resources allow the group to settle its obligations as they fall due.

Contractual obligations and commitments

£m	Total	Payments due by period			
		Less than 1 year	Between 1 and 3 years	Between 3 and 5 years	More than 5 years
Loans and other borrowings ^a	9,565	483 ^b	1,722	2,087	5,273
Finance lease obligations	294	2	35	22	235
Operating lease obligations	7,192	464	853	756	5,119
Capital commitments	467	455	10	1	1
Pension deficit obligations	9,962	–	1,183	1,256	7,523
Total	27,480	1,404	3,803	4,122	18,151

^a Excludes fair value adjustments for hedged risks.

^b Includes £266m of accrued interest within less than one year.

Off-balance sheet arrangements

As disclosed in the consolidated financial statements, there are no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on the group's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditure or capital resources, with the exception of financial commitments and contingent liabilities disclosed in note 30 to the consolidated financial statements.

Quantitative and qualitative disclosures about interest, foreign exchange, credit and liquidity risks

A discussion of the group's financial risk management objectives and policies and the exposure of the group to interest rate, foreign exchange, credit and liquidity risk is included in note 29 to the consolidated financial statements.

Going concern

The **Business review** on pages 8 to 43 includes information on the group structure, the performance of each of the lines of business, the impact of regulation and competition and principal risks and uncertainties. This **Financial review** includes information on our financial results, financial outlook, liquidity, funding and capital management and our financial position and resources. Notes 15, 16, 20, 21 and 29 of the consolidated financial statements include information on the group's investments, cash and cash equivalents, borrowings, derivatives, financial risk management objectives, hedging policies and exposures to interest, foreign exchange, credit, liquidity and market risks.

Alongside the factors noted above, the directors have considered the group's cash flow forecasts, in particular with reference to the period to the end of May 2012. The directors are satisfied that this cash flow forecast, taking into account reasonably possible risk sensitivities associated with this forecast and the group's current funding and facilities, alongside the group's funding strategy, shows that the group will continue to operate for the foreseeable future. The directors therefore continue to have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future and continue to adopt a going concern basis (in accordance with the guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' issued by the Financial Reporting Council) in preparing the consolidated financial statements.

There has been no significant change in the financial or trading position of the group since 31 March 2011.

FINANCIAL POSITION AND RESOURCES

Summarised balance sheet

	2011 £m	2010 £m
Non-current assets		
Goodwill & acquisition related intangible assets	1,566	1,720
Property, plant and equipment & software	16,446	16,808
Deferred tax asset	461	2,196
Trade and other receivables	286	336
Other non-current assets	850	1,335
	19,609	22,395
Current assets		
Cash and cash equivalents	351	1,452
Trade and other receivables	3,332	3,696
Other current assets	248	1,137
	3,931	6,285
Current liabilities		
Trade and other payables	6,114	6,531
Loans and other borrowings	485	3,269
Other current liabilities	432	620
	7,031	10,420
Non-current liabilities		
Loans and other borrowings	9,371	9,522
Provisions	807	707
Deferred tax liability	1,212	1,456
Retirement benefit obligations	1,830	7,864
Other non-current liabilities	1,338	1,337
	14,558	20,886
Total equity (deficit)	1,951	(2,626)

Balance sheet items

Goodwill and acquisition related intangible assets

Goodwill decreased by £75m during 2011 to £1,357m. This reduction primarily reflected an impairment of £39m and the impact of foreign exchange movements. Acquired intangible assets decreased by £79m during 2011 to £209m, principally due to amortisation of £61m, impairments of £10m and the impact of foreign exchange movements.

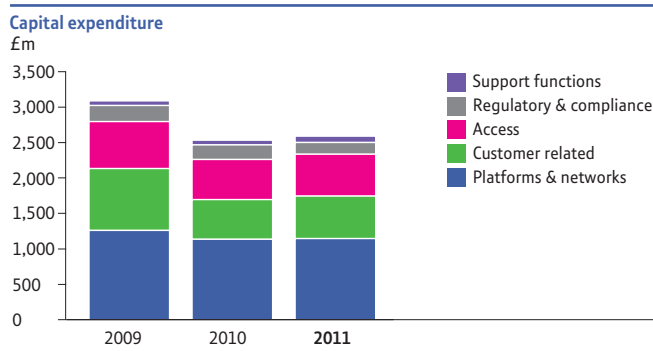
Property, plant and equipment and software

Property, plant and equipment and internally developed and purchased software decreased by £362m to £16,446m at 31 March 2011, principally due to capital expenditure of £2,590m, (further details of which are given below) which was more than offset by £2,979m of depreciation and amortisation.

Capital expenditure

Capital expenditure, on an accruals basis, totalled £2,590m in 2011 (2010: £2,533m; 2009: £3,088m), in line with our expectations of around £2.6bn.

The capital expenditure by major area over the last three years is shown below.



In 2011 platforms and networks expenditure was £1,145m (2010: £1,135m). A significant element of the platform expenditure was on our super-fast fibre-based broadband services network. To date, we have spent £0.6bn of our £2.5bn potential investment in our fibre roll-out programme. This expenditure is being managed within our capital expenditure plans. Access expenditure was £591m (2010: £566m) for connecting our customers to the network. Customer related expenditure was £599m (2010: £560m), principally relating to major customer contracts in BT Wholesale and BT Global Services. This also included product development, testing and fault reduction investments across the group.

Of the capital expenditure, £227m (2010: £280m) arose outside of the UK. Contracts placed for ongoing capital expenditure totalled £467m at 31 March 2011 (2010: £383m).

Capital expenditure for the last five financial years is included in the **Financial statistics** section on page 160.

Deferred tax

The deferred tax asset of £461m (2010: £2,196m) relates to the group's retirement benefit obligations, as detailed in note 23 to the consolidated financial statements. The deferred tax liability decreased by £244m to £1,212m at 31 March 2011, mainly reflecting the 2% reduction in the rate of UK corporation tax, effective 1 April 2011. Movements in deferred tax assets and liabilities are disclosed in note 24 to the consolidated financial statements.

Cash and cash equivalents

For further details on cash and cash equivalents refer to **Liquidity and Funding and capital management** on pages 50 and 52 respectively.

Trade and other receivables

Current trade and other receivables decreased by £364m to £3,332m at 31 March 2011 principally reflecting improvements to working capital in BT Global Services.

Trade and other payables

Trade and other payables decreased by £417m to £6,114m at 31 March 2011 principally reflecting the impact of the reduction in our cost base in 2011.

Loans and other borrowings

For further details of movements in our loans and other borrowings, see **Net debt** on page 52.

Provisions

Current and non-current provisions increased by £115m to £956m at 31 March 2011. The movements in provisions are disclosed in note 25 to the consolidated financial statements.

Retirement benefit obligations

A summary of movements in the IAS 19 accounting deficit is set out below:

Deficit	2011 £bn	2010 £bn
At 1 April	(7.9)	(4.0)
Current service cost	(0.3)	(0.2)
Interest	(0.1)	(0.3)
Actuarial gain (loss)	5.2	(4.3)
Contributions	1.3	0.9
At 31 March	(1.8)	(7.9)
Deferred tax asset	0.4	2.2
Net of deferred tax at 31 March	(1.4)	(5.7)

The market value of the BTPS assets have increased by £1.7bn since 31 March 2010 to £37.0bn at 31 March 2011 principally reflecting the continuation of strong asset performance with a 7% return and deficiency contributions of £1.0bn offsetting benefits paid of £2.0bn. At 31 March 2011 the value of the BTPS liabilities have decreased by £4.3bn to £38.7bn principally as a result of the £3.5bn impact of the UK Government decision that the Consumer Prices Index (CPI), rather than the Retail Prices Index (RPI), will be used for revaluation and indexation of occupational pension rights. The present value of the liabilities continues to reflect the low real yield on bonds over the last two years. Further details and detailed pensions accounting disclosures are provided in note 23 to the consolidated financial statements.

Equity

A summary of the movements in equity is set out below:

	2011 £m	2010 £m
(Deficit) equity at 1 April	(2,626)	169
Profit for the year	1,504	1,029
Other comprehensive income (loss)	3,449	(3,661)
Dividends to shareholders	(543)	(263)
Share-based payment	68	81
Tax on share-based payment	91	19
Net issue of treasury shares	8	4
Movements in non-controlling interests	-	(4)
Equity (deficit) at 31 March	1,951	(2,626)

The increase in equity in 2011 is principally due to the profit for the year and the recognition of actuarial gains on retirement benefit obligations.

BT Group plc, the parent company, had a profit and loss reserve, net of the treasury reserve, of £9,198m at 31 March 2011. The financial statements of BT Group plc are prepared in accordance with UK GAAP.

Other comprehensive income

Included in other comprehensive income for 2011 of £3,449m (2010: £3,661m other comprehensive loss) are actuarial gains of £5,109m (2010: £4,324m loss), foreign exchange losses on the translation of overseas operations of £140m (2010: £119m loss), net fair value losses on cash flow hedges of £14m (2010: £575m) and a tax charge of £1,521m (2010: £1,350m credit) relating to items recognised in other comprehensive income.

Treasury shares

At 31 March 2011 the company held 389m shares (2010: 401m) in Treasury. These shares are used to settle exercises of share options and share awards. The carrying value of £1,078m (2010: £1,105m) has been deducted from retained earnings.

Acquisitions and disposals

We actively review our portfolio of assets and acquisition opportunities in our target markets. We will consider acquiring companies if they bring us skills, technology, geographic reach or time-to-market advantage for new products and services.

During 2011 there were no acquisitions. However, we completed the following equity investments:

Date	Investment
May 2010	A 2.6% shareholding in OnLive Inc., a Silicon Valley based, cloud computing video gaming business. BT has exclusive rights to bundle the OnLive® Game Service with broadband in the UK.
September 2010	A 14.3% shareholding in YouView TV Limited, a joint venture between the BBC, ITV, BT, Channel 4 and others to bring a new free-to-air internet-connected TV service to UK homes.

Also during 2011 we completed the following disposal:

Date	Disposal
December 2010 and March 2011	A 6.5% interest in our associate Tech Mahindra was sold for total consideration of £74m.

We also completed a number of other minor disposals in 2011.

Legal proceedings

We do not believe that there is any single current court action that would have a material adverse effect on the financial position or operations of the group. During 2011 the aggregate volume and value of legal actions to which the group is party remained broadly the same as at the end of 2010, during which the levels had increased significantly.

Principal accounting policies, critical accounting estimates and key judgements

Our principal accounting policies are set out on pages 91 to 99 of the consolidated financial statements and conform with IFRS. These policies, and applicable estimation techniques, have been reviewed by the directors who have confirmed them to be appropriate for the preparation of the 2011 consolidated financial statements.

We, in common with virtually all other companies, use estimates in the preparation of our consolidated financial statements. Details of critical accounting estimates and key judgements are provided in the accounting policies on pages 97 and 98.

ALTERNATIVE PERFORMANCE MEASURES

Introduction

We assess the performance of the group using a variety of alternative performance measures. We principally discuss the group's results on an 'adjusted' basis. The rationale for using adjusted measures is explained below. Results on an adjusted basis are presented before specific items.

We also explain financial performance using measures that are not defined under IFRS and are therefore termed 'non-GAAP' measures. The non-GAAP measures we use are reported and adjusted EBITDA, reported and adjusted free cash flow and net debt. A reconciliation from these non-GAAP measures to the nearest measure prepared in accordance with IFRS is presented below. The alternative performance measures we use may not be directly comparable to similarly titled measures used by other companies.

Specific items

Definition

The group's income statement and segmental analysis separately identify trading results before specific items. Specific items are those that in management's judgment need to be disclosed by virtue of their size, nature or incidence. In determining whether an event or transaction is specific, management considers quantitative as well as qualitative factors such as the frequency or predictability of occurrence. This is consistent with the way that financial performance is measured by management and reported to the Board and the *Operating Committee* and assists in providing a meaningful analysis of the trading results of the group. The directors believe that presentation of the group's results in this way is relevant to an understanding of the group's financial performance as specific items are identified by virtue of their size, nature or incidence.

Items which have been considered to be specific items by virtue of their size, nature or incidence include disposals of businesses and investments, business restructuring programmes, asset impairment charges, property rationalisation programmes and the settlement of multiple tax years in a single payment. In 2011 net interest on pensions has been included in specific items because of its volatile nature, and also BT Global Services contract and financial review charges in 2009, by virtue of their size and nature. Accordingly, specific items for comparative periods have been re-presented to reflect this reclassification.

Specific items in 2011, 2010 and 2009

Specific items recognised in all years are summarised below and disclosed in note 8 to the consolidated financial statements.

Revenue and other operating income

In 2010 a charge of £52m was recognised as a reduction in revenue, reflecting an Ofcom determination in relation to 2Mbps partial private circuits. In 2009 the group recognised BT Global Services contract and financial review charges, of which £41m was recognised as a reduction in revenue.

In 2009 a £13m loss on disposal arose from exiting a business and was recognised as a reduction in other operating income.

Operating costs

Specific operating costs of £329m (2010: £427m; 2009: £1,993m) comprised:

- BT Global Services restructuring charges of £192m (2010: £301m; 2009: £280m). This included people and property charges of £129m (2010: 132m; 2009: £51m) principally comprising leaver costs and property exit costs and networks, products and procurement channels rationalisation charges of £41m (2010: £142m; 2009: £183m) from rationalising legacy networks, including the associated systems and processes. In 2010, the charge of £142m included a payment of £127m made to Tech Mahindra for the renegotiation of certain supply contracts as part of the rationalisation of procurement channels. In addition intangible asset impairments and other charges of £22m were recognised (2010: £27m; 2009: £46m). Further BT Global Services restructuring charges of around £50m are expected to be incurred in 2012 principally in relation to the network rationalisation programme.
- Property rationalisation charges of £88m (2010: £121m; 2009: £nil) in relation to the rationalisation of the group's UK property portfolio.
- Intangible assets impairment charges of £49m (2010 and 2009: £nil) relating to goodwill and brands.
- BT Global Services contract and financial review charges of £1,598m were recognised in 2009.
- A charge of £65m in respect of the group's transformation and reorganisation activities was recognised in 2009.
- A £50m charge was recognised in 2009 comprising £31m of asset impairments and £19m of associated costs, following the group's review of its 21CN programme and associated voice strategy.

Net finance expense

Net finance expense on pensions was £79m (2010: £279m expense; 2009: £313m income).

Associates and joint ventures

In 2011 a profit of £42m arose on the disposal of a 6.5% interest in our associate Tech Mahindra. In 2010 a loss on disposal of £12m arose on the disposal of an indirect interest in Tech Mahindra. In 2010 the group also recognised a credit of £29m in connection with the £127m payment to its associate Tech Mahindra, as described above. In 2009 a credit of £36m was recognised in respect of a reassessment of the value of the group's share of the net assets of an associated undertaking.

Taxation

The specific tax credit of £239m in 2011 (2010: £420m; 2009: £414m) comprised:

- Tax credit of £72m (2010: £190m; 2009: £414m) on the specific items detailed above.
- Tax credit of £172m (2010 and 2009: £nil) for the re-measurement of deferred tax balances as a result of the change in the UK statutory corporation tax rate from 28% to 26% effective in 2012.
- In 2010 the group agreed substantially all outstanding tax matters with HMRC relating to the 2008, 2007 and 2006 tax years resulting in a tax repayment. Specific items in 2010 included a tax credit of £230m, associated interest of £11m on the repayment and operating costs of £5m representing costs associated with the settlement.

EBITDA

In addition to measuring financial performance of the lines of business based on operating profit, we also measure performance based on EBITDA and adjusted EBITDA. EBITDA is defined as the group profit or loss before depreciation, amortisation, net finance expense and taxation. Adjusted EBITDA is defined as EBITDA before specific items. EBITDA is a common measure used by investors and analysts to evaluate the operating financial performance of companies, particularly in the telecommunications sector.

We consider EBITDA and adjusted EBITDA to be useful measures of our operating performance because they reflect the underlying operating cash costs, by eliminating depreciation and amortisation. EBITDA and adjusted EBITDA are not direct measures of our liquidity, which is shown by our cash flow statement, and need to be considered in the context of our financial commitments.

A reconciliation from group operating profit, the most directly comparable IFRS measure, to reported and adjusted group EBITDA, is set out below. A reconciliation between operating profit and adjusted EBITDA for our lines of business is set out in **Segment information**, note 1 to the consolidated financial statements on page 106.

	2011 £m	2010 £m	2009 £m
Operating profit	2,578	2,123	301
Depreciation and amortisation	2,979	3,039	2,890
Reported EBITDA	5,557	5,162	3,191
Specific items	329	477	2,047
Adjusted EBITDA	5,886	5,639	5,238

Adjusted earnings per share

We also measure financial performance based on adjusted earnings per share, which excludes specific items. Basic and adjusted earnings per share, and the per share impact of specific items, is as follows:

Year ended 31 March 2011	Pence per share	£m
Basic earnings per share/profit^a	19.4	1,502
Specific items	1.6	127
Adjusted basic earnings per share/profit	21.0	1,629

Year ended 31 March 2010	Pence per share	£m
Basic earnings per share/profit^a	13.3	1,028
Specific items ^b	4.0	308
Adjusted basic earnings per share/profit^b	17.3	1,336

Year ended 31 March 2009 ^b	Pence per share	£m
Basic loss per share/(loss)^a	(2.5)	(193)
Specific items ^b	16.6	1,284
Adjusted basic earnings per share/profit^b	14.1	1,091

^a The stated profit (loss) amounts are the component of the total profit (loss) which is attributable to equity shareholders excluding non-controlling interests.

^b Re-presented – see page 56.

Free cash flow

Reported free cash flow

Reported free cash flow is one of the group's key performance indicators by which our financial performance is measured. Reported free cash flow is defined as the net increase in cash and cash equivalents less cash flows from financing activities (except net interest paid) and less the acquisition or disposal of group undertakings and less the net sale of short-term investments and excluding pension deficit payments. Reported free cash flow is primarily a liquidity measure, however we also believe it is an important indicator of our overall operational performance as it reflects the cash we generate from operations after capital expenditure and financing costs, both of which are significant ongoing cash outflows associated with investing in our infrastructure and financing our operations. In addition, reported free cash flow excludes cash flows that are determined at a corporate level independently of ongoing trading operations such as dividends, share buy backs, acquisitions and disposals and repayment of debt. Our use of the term reported free cash flow does not mean that this is a measure of the funds that are available for distribution to shareholders.

Adjusted free cash flow

We also measure financial performance based on an adjusted basis before specific items. Adjusted free cash flow is before the cash impact of specific items including tax related specific items. For non-tax related specific items, the adjustment is made on a pre-tax basis. Adjusted free cash flow provides an additional measure of the free cash flow generated by the group based on its trading performance.

A reconciliation from net cash inflow from operating activities, the most directly comparable IFRS measure, to reported and adjusted free cash flow is set out below.

Year ended 31 March	2011 £m	2010 £m	2009 £m
Net cash inflow from operations	4,566	4,825	4,706
Add back pension deficit payment	1,030	525	-
Included in cash flows from investing activities			
Net capital expenditure	(2,630)	(2,480)	(3,038)
Interest received	29	16	19
Dividends received from associates	7	3	6
Purchases of non-current financial assets	(18)	-	-
Included in cash flows from financing activities			
Interest paid	(973)	(956)	(956)
Reported free cash flow	2,011	1,933	737
Net cash outflow from specific items	212	173	35
Adjusted free cash flow	2,223	2,106	772

The net cash outflow from specific items of £212m in 2011 principally comprised BT Global Services restructuring charges and property rationalisation costs. The net cash outflow of £173m in 2010 principally comprised BT Global Services restructuring charges and property rationalisation costs, offset by a cash receipt of £226m following the agreement of substantially all outstanding tax matters with HMRC relating to the 2008, 2007 and 2006 tax years. The net cash outflow of £35m in 2009 principally comprised BT Global Services restructuring costs and group transformation costs.

Net debt

Net debt consists of loans and other borrowings (both current and non-current), less current asset investments and cash and cash equivalents. Loans and other borrowings are measured at the net proceeds raised, adjusted to amortise any discount over the term of the debt. For the purpose of this measure, current asset investments and cash and cash equivalents are measured at the lower of cost and net realisable value. Currency denominated balances within net debt are translated to Sterling at swapped rates where hedged.

This definition of net debt measures balances at the expected value of future undiscounted cash flows due to arise on maturity of financial instruments and removes the balance sheet adjustments made from the re-measurement of hedged risks under fair value hedges and the use of the effective interest method. In addition, the gross balances are adjusted to take account of netting arrangements.

Net debt is a measure of the group's net indebtedness that provides an indicator of the overall balance sheet strength. It is also a single measure that can be used to assess both the group's cash position and indebtedness. There are material limitations in the use of alternative performance measures and the use of the term net debt does not necessarily mean that the cash included in the net debt calculation is available to settle the liabilities included in this measure.

Net debt is considered to be an alternative performance measure as it is not defined in IFRS. The most directly comparable IFRS measure is the aggregate of loans and other borrowings (current and non-current), current asset investments and cash and cash equivalents. A reconciliation from this measure, the most directly comparable IFRS measure, to net debt is given below.

At 31 March	2011 £m	2010 £m
Loans and other borrowings	9,856	12,791
Less:		
Cash and cash equivalents	(351)	(1,452)
Current asset investments	(19)	(406)
	9,486	10,933
Adjustments:		
To retranslate currency denominated balances at swapped rates where hedged	(408)	(1,326)
To remove fair value adjustments and accrued interest applied to reflect the effective interest method	(262)	(324)
Net debt	8,816	9,283