

Financial review

Introduction

BT's earnings of 32.8 pence per share for the year ended 31 March 1997 were 3.7% above the previous year's. The results have benefited from the strong growth in demand for the group's products and services, particularly the newer advanced services such as FeatureNet, together with reduced redundancy charges. These factors were partially offset by substantial price reductions in the year benefiting customers by over £800 million. The group's results are summarised in the following table:

	1997 £m	1996 £m	Increase (decrease) %
Turnover	14,935	14,446	3.4
Operating costs before redundancy costs	(11,323)	(10,925)	3.6
Redundancy costs	(367)	(421)	(12.8)
Operating profit	3,245	3,100	4.7
Group's share of profits of associated undertakings	139	82	
Profit on sale of group undertakings	8	7	
Net interest and premium payable	(189)	(170)	
Profit before taxation	3,203	3,019	6.1
Taxation	(1,102)	(1,027)	
Profit after taxation	2,101	1,992	5.5
Minority interests	(24)	(6)	
Profit for the financial year	2,077	1,986	4.6
Earnings per share	32.8p	31.6p	3.7

Regulation and prices

The year to 31 March 1997 was the last full financial year in which the majority of BT's main UK services were subject to price regulation. Under current price controls which are in force up to 31 July 1997, BT has had to reduce its overall prices for its main UK services, principally inland and outgoing international call services and exchange line rentals, under the RPI minus 7.5 formula. In the current price control year to 31 July 1997, BT has reduced its prices by about 5% after reducing them by nearly 2% in the previous year. This price control is estimated to have affected slightly over 50% of the group's total turnover for the year ended 31 March 1997.

From 1 August 1997, a new retail price control will apply under which a cap of RPI minus 4.5 will apply to the services used by the lowest 80% of BT's residential customers by bill size. This new retail price control is estimated to cover services representing about 18% of the group's total turnover for the year to 31 March 1997.

Interconnect charges are a key element in the development of network competition. Of tel is planning to introduce changes to the current controls on network charges later this year. The proposed arrangements are likely to shift the basis for setting charges from fully allocated historic costs to long-run incremental costs and to replace annual determinations of each interconnect charge with a system based on RPI minus price caps.

Competition and the UK economy

BT has a significant share in its main UK markets for telephone calls and provision of exchange lines. But competition is eroding BT's share in key market sectors in particular areas of the UK and for certain products and services. Figures published by Of tel indicated that BT had 79% of the market for national calls for the quarter ended 30 September 1996, compared with 80% a year earlier, and supplied 91% of the exchange lines in the UK at 30 September 1996, compared with 94% a year earlier. In the mobile telecommunications market, Cellnet continues to face strong competition from its direct competitor and the two personal communications operators in the UK.

BT expects the competitive pressure to persist and it will continue to defend its market share vigorously and fairly.

The strength of the UK economy is an important determinant of BT's business volumes and the gross domestic product grew by 3.0% in the year ended 31 March 1997, compared with 2.0% in the previous year.

Turnover

Total turnover grew by 3.4% to £14,935 million in the year. The strong growth in demand for the group's products and services of approximately 8% was partially offset by the effect of price reductions which averaged over 5% across the business.

The group's turnover is analysed as follows:

	1997 £m	1996 £m	Change %
Inland telephone calls	4,874	4,882	(0.2)
International telephone calls	1,809	1,980	(8.6)
Telephone exchange line rentals	2,811	2,685	4.7
Private circuits	1,124	1,056	6.4
Mobile communications	949	856	10.9
Customer premises equipment supply	914	946	(3.4)
Yellow Pages and other directories	438	408	7.4
Other sales and services	2,016	1,633	23.5
Total turnover	14,935	14,446	3.4

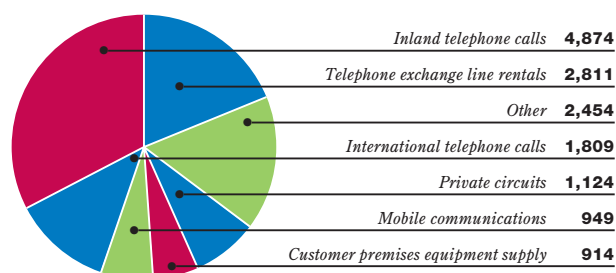
Price reductions had a major impact on inland telephone call turnover for the third year in succession. Innovative marketing programmes included enhancements to the successful Friends & Family package, an extension to Business Options and reductions in local and national call prices. The combined effect of these price changes totalled over £300 million, which was equivalent to a 7% reduction in call prices following falls of 7% and 12% in the previous two years.

Call volume growth of 7% almost wholly mitigated the price reduction effect, resulting in total inland call turnover remaining static in the year. ISDN calls and

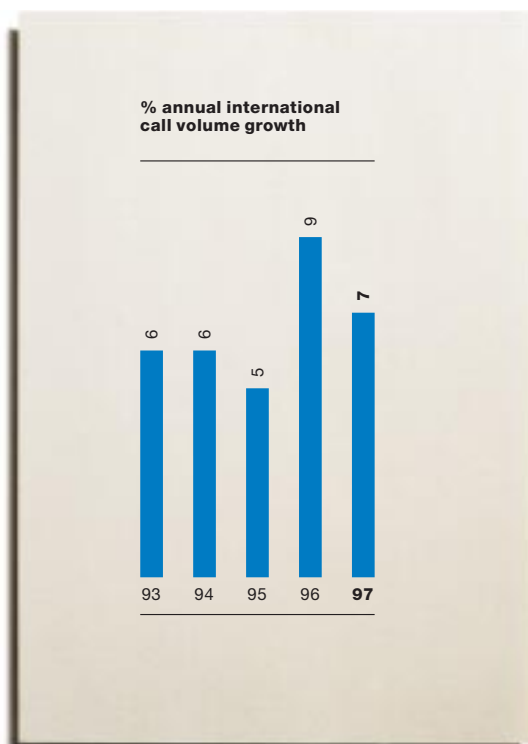
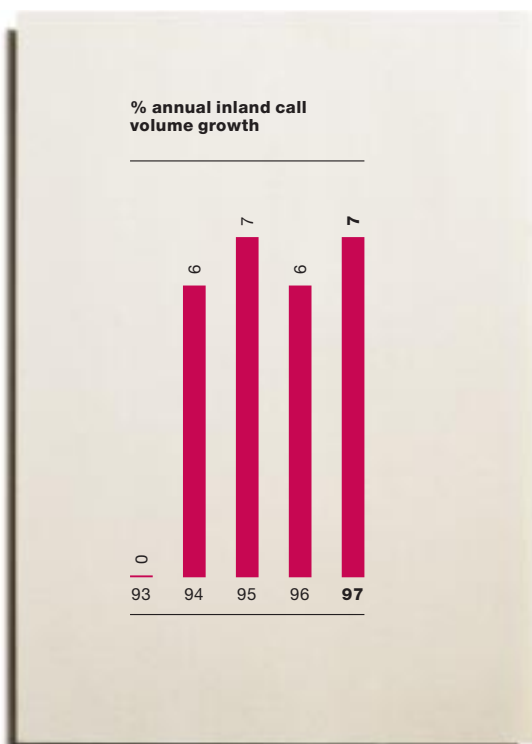
telemarketing services, including 0800 numbers, were the main areas of this strong volume growth, together with fixed to mobile and local fixed network calls.

International call turnover declined by 8.6% as a result of price reductions averaging over 13% and the impact of the strengthening of sterling in the year, partially offset by the strong volume growth of 7%. BT is reducing prices substantially on most international routes in the face of increasing competition.

Turnover by category £m Total 14,935



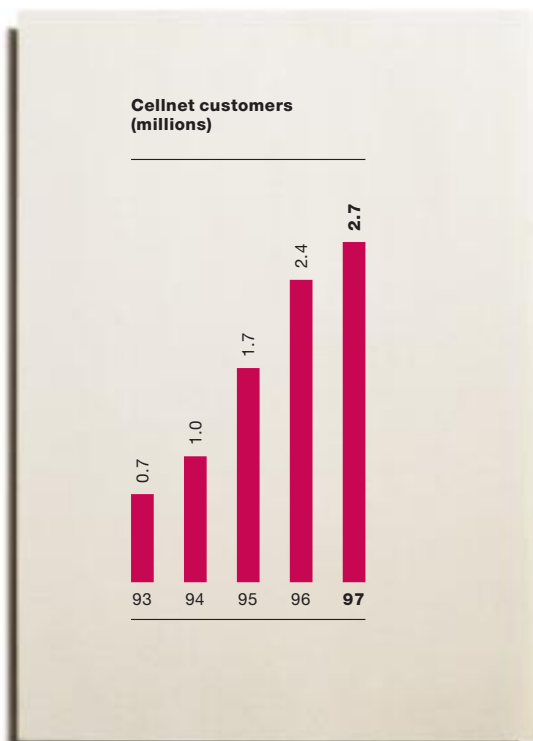
Turnover from exchange line rentals grew by 4.7%. The increased turnover was the combined result of the growth in business line connections and a 3% price increase in July 1996. The number of business line connections grew by 5.3% in the year with high-speed ISDN services mainly contributing to this growth. The number of residential lines declined slightly due to the competition from cable operators. Overall, BT's total exchange line connections grew by 0.9% to 27.6 million.



Private circuit turnover rose by 6.4% with the demand for KiloStream and MegaStream services continuing at a high level.

Mobile communications turnover increased by 10.9% in the year to £949 million, reflecting the 12.9% growth in Cellnet's customer base, offset by the effect of substantial reductions in mobile call prices. Cellnet had 2.7 million customer connections, of which over 1.1 million were digital, at 31 March 1997.

BT's expanding overseas operations in Continental Europe, including the group's systems integration business and the sales of advanced and managed network services, were the main elements behind the growth of 23.5% in other sales and services. Concert Communications' services were in increasing demand with turnover rising rapidly. The acquisition of a business based in the Netherlands in April 1996 largely contributed to the growth in systems integration turnover.



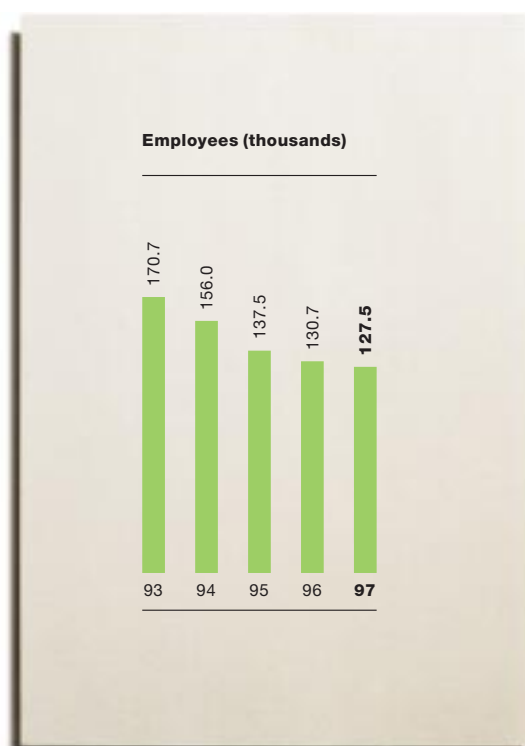
Operating costs

Total operating costs increased by 3.0% in the year. As a percentage of turnover, operating costs decreased from 78.5% in the previous financial year to 78.3%.

	1997 £m	1996 £m	Change %
Staff costs	3,778	3,680	2.7
Own work capitalised	(399)	(417)	(4.3)
Depreciation	2,265	2,189	3.5
Payments to telecommunication operators	1,476	1,383	6.7
Other operating costs	4,309	4,193	2.8
Other operating income	(106)	(103)	2.9
Total operating costs, before redundancy charges	11,323	10,925	3.6
Redundancy charges	367	421	(12.8)
Total operating costs	11,690	11,346	3.0

Staff costs increased by 2.7% as a result of the effects of the annual pay awards, acquired subsidiaries, and a higher allocation for the employee share ownership scheme, offset by savings resulting from the continuing staff reductions.

There was a 3,200 net reduction in group staff numbers in the year with over 5,500 people leaving under early release terms. This reduction is a substantially lower figure than in recent years.



In recognition of the contribution made by BT's employees, the allocation of £64 million for the employee share ownership scheme was set by the Board during the year at 2% of pre-tax profit, compared with a figure of approximately 1% allocated in previous years.

The depreciation charge increased by 3.5% reflecting BT's continuing high level of investment in its network.

Payments to other telecommunication operators grew by 6.7% as a result of BT's expanding operations overseas and the growing number of calls terminating on UK competitors' networks. Payments to overseas operators for incoming calls terminating in the UK fell significantly as a consequence of falling prices and the strengthening of sterling in the year more than offsetting call volume growth.

Other operating costs, which rose by 2.8% in the year, include the maintenance and support of the networks, the costs of occupancy, marketing and BT's overseas operations and the cost of sales of customer premises equipment. In the UK's increasingly competitive telecommunications market, BT is spending significantly more on its marketing programmes, including extensive TV advertising, and this has been one of the two main factors behind the increase in costs. The other has been the costs incurred in supporting Cellnet's recent rapid expansion.

The redundancy costs of £367 million were incurred as a result of the workforce reductions discussed above. These costs include £258 million relating to incremental pension benefits. In view of the surplus in the group's main pension scheme described below, redundancy charges for the year ending 31 March 1998 will not include the costs of these benefits under BT's current accounting policies.

Operating profit

Operating profit for the year of £3,245 million was £145 million (4.7%) higher than in the previous year.

Associates, bond repurchase and interest charge

The group's £139 million share of profits of associated undertakings consists primarily of the company's share of MCI's profits less BT's share of losses in its joint ventures in Germany and elsewhere in Europe which are in the course of establishing their businesses. BT's share of MCI's pre-tax profit for the year amounted to £175 million, under BT's accounting policies, compared with £101 million for the previous year which had been adversely affected by a restructuring charge, BT's share of which was £73 million.

During August 1996, the company took the opportunity to repurchase two of the then remaining series of Government held bonds for £422 million, at an effective premium of £60 million which has been charged against profit in accordance with UK accounting standards. The last remaining series was repaid on its maturity in March 1997. The repurchase has reduced the overall effective interest rate on BT's borrowings.

The net interest charge of £129 million, excluding the bond repurchase premium, was £41 million or 24% lower than the interest charge in the previous year. The group's strong positive cash flow was the main contributor to this lower charge which was covered 25 times by operating profit.

Following the completion of the proposed merger with MCI and the payment of the special dividend described below, the group's borrowings will increase significantly and its interest charge will rise commensurately. Interest cover, however, is expected to be at a comfortable level.

Profit and taxation

The group's profit before taxation for the year was £3,203 million, an increase of 6.1% on the previous year. The tax charge of £1,102 million as a percentage of profit before taxation was 34.4%, compared with 34.0% for the previous year. The higher effective rate in the year was due to the premium on the bond repurchase not being wholly allowable for tax relief.

HM Government, newly elected on 1 May 1997, has stated that it is proposing to levy a windfall tax on those regulated companies privatised since 1979. The company has no knowledge whether such a tax will be levied upon it, nor the basis on which it would be levied or the amount if the tax was to apply to the company. HM Government has indicated that it will be announcing tax measures in June or July 1997.

Earnings and dividends

Earnings per share, based on a profit for the financial year of £2,077 million, were 32.8 pence.

The ordinary dividends paid and recommended of 19.85 pence per share represent a 6.1% increase on the previous year and are covered 1.7 times by earnings. These dividends comprise the interim dividend of 7.9 pence per share, which was paid in February 1997, and the proposed final dividend of 11.95 pence per share which, if approved at the annual general meeting, will be paid on 22 September 1997 to shareholders on the register on 15 August 1997. The proposed final dividend is that forecast by the Board in its announcement of the MCI merger in November 1996. These ordinary dividends will absorb £1,266 million.

Additionally, as originally announced in November 1996, the company will be paying a special dividend of 35 pence per share. This dividend, which absorbs £2,244 million, will also be paid on 22 September 1997 to shareholders on the register on 15 August 1997. The Board believes that shareholder value and earnings growth will be enhanced through the introduction of more gearing which will be achieved with this payment. In the event that the merger with MCI is completed before this record date, alternative arrangements for the final and special dividends will be made. The majority of the group's employees participate in one or more of the BT option schemes. Since share option holders are not entitled to the special dividend and could be otherwise disadvantaged by its payment, arrangements will be put in place to compensate the option holders.

The Board intends to adjust the level of ongoing annual dividends to take into account the effect of the special dividend in order broadly to maintain the yield on the company's shares. This adjustment will first be made for the interim dividend for the year ending 31 March 1998.

Dividends will continue to be an important component of shareholder value. The Board believes that earnings and cash flow will continue to be strong enough to support a growing dividend (as adjusted for the effect of the special dividend). The intention will be to grow earnings at a higher level, which would lead to an increase in dividend cover over time.

Financing

	1997 £m	1996 £m
Net cash inflow from operating activities	6,192	5,834
Net cash outflow for returns on investments and servicing of finance	(220)	(150)
Tax paid	(1,045)	(784)
Capital expenditure and financial investment	(2,820)	(2,500)
Acquisitions and disposals	(252)	(132)
Equity dividends paid	(1,217)	(1,138)
Net cash inflow before use of liquid resources and financing	638	1,130
Management of liquid resources	(504)	(1,317)
Net cash inflow (outflow) from financing	(224)	215
Net increase (decrease) in cash and cash equivalents	(90)	28
Decrease in net debt	849	1,319

The cash flow statement presentation has been modified to conform with the 1996 revision of Financial Reporting Standard 1.

Net cash inflow from operating activities of £6,192 million in the year was 6.1% higher than in the previous year.

Tax paid in the year, principally on the prior year's profit, amounted to £1,045 million. The increase of £261 million on the previous year is mainly due to the higher level of profit made in the year to 31 March 1996 compared to the prior year.

Net cash outflow for capital expenditure and financial investment mainly comprises expenditure on plant, equipment and property of £2,823 million.

In the year, the group drew down £235 million in loans and repaid debt of £670 million, including £501 million of Government held bonds discussed above. During the year, the group also received £160 million for new shares subscribed by employees, principally following the exercise of savings-related share options.

The Board believes that, after the merger with MCI, the enlarged group's cash flow will be more than adequate to cover its capital commitments and the dividend payments on the enlarged capital.

Treasury policy

The group has a centralised treasury operation. Its primary role is to manage liquidity, funding, investment and the group’s financial risk, including risk from volatility in currency and interest rates and counterparty credit risk. The treasury operation is not a profit centre and the objective is to manage risk at optimum cost.

The Board sets the department’s policy, and its activities are subject to a set of controls commensurate with the magnitude of the investments and borrowings under its management. Counterparty credit risk is closely monitored and managed within controls set by the Board. Derivative instruments, including forward foreign exchange contracts, are entered into for hedging purposes only.

Capital resources

At 31 March 1997, the group had cash and short-term investments of £3,000 million. At that date, £221 million of short-term debt was outstanding.

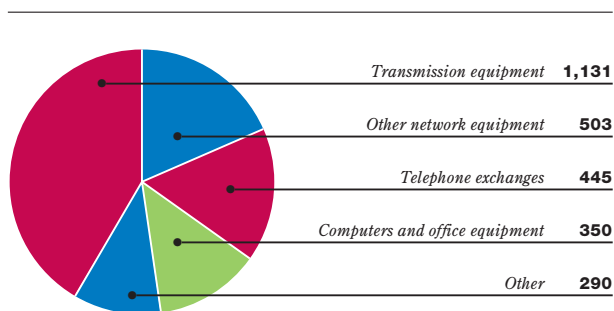
The gearing or ratio of debt (borrowings net of cash and short-term investments) to shareholders’ equity and minority interests was 1.6% at 31 March 1997, compared with 7.4% at 31 March 1996. The group had £176 million net debt at 31 March 1997, a decrease of £849 million in the year through cash flow. Gearing is planned to increase substantially during the course of 1997 as a result of the special dividend and the merger with MCI, but the Board believes that it will begin to fall after 1998. BT issued a \$1.5 billion five-year 6¾% Eurobond in April 1997 and has subsequently announced the issue of a \$1.0 billion ten-year 7% Eurobond in preparation for the group’s cash requirements later in 1997.

The directors have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future and therefore they continue to adopt the going concern basis in preparing the financial statements.

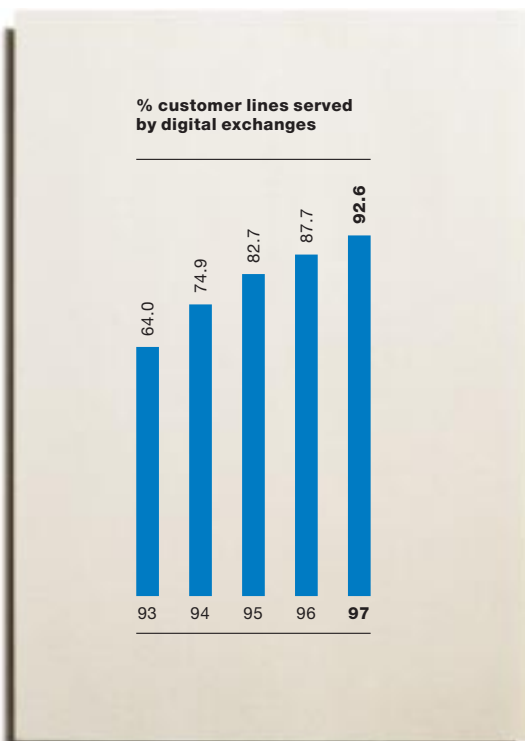
Capital expenditure

Capital expenditure on plant, equipment and property totalled £2,719 million in the year, and was similar to the level of the previous year. Investment has been concentrated on improving the quality of the local access network and extending the reach of advanced services by making further progress in converting the UK’s few remaining electronic telephone exchanges to full digital operation. Additionally, Cellnet has continued the construction of the digital cellular GSM network.

Expenditure on tangible fixed assets £m Total 2,719



The group expects capital expenditure by the business, as currently constituted, in the year ending 31 March 1998 to be at a level commensurate with that of the year under review. BT expects that future capital expenditure will be provided from net cash inflows from operating activities supplemented, if appropriate, by external financing.



Acquisitions and joint ventures

In April 1996 the group acquired the Rijnhaave group, a Netherlands-based systems integration business and, in March 1997, completed the formation of a joint venture with the Dutch railways organisation to offer telecommunication services in that country. In February 1997, BT agreed to acquire the 50% interest in its Spanish joint venture it did not already own, thereby obtaining full control. Also, in March 1997, the group acquired a 22.5% interest in Bharti Cellular, a mobile telecommunications operator based in India. The goodwill arising on these acquisitions amounted to £166 million; the remaining goodwill of £33 million taken to reserves in the year mainly related to BT's share of goodwill arising on MCI's acquisitions, principally on its new joint venture in Mexico.

In September 1996, BT announced that it would be taking a 26% interest in CEGETEL, the French telecommunications operator which has a majority interest in SFR, a leading mobile provider in France, for a consideration of approximately £1 billion. This transaction is due to be completed later in 1997.

Return on capital employed

The group made a return of 18.9% on the average capital employed, on a historical cost basis, in its business in the year ended 31 March 1997, compared with a return of 18.3% in the previous year.



Pensions

BT has recently received the preliminary results of an actuarial valuation, as at 31 December 1996, of its main pension fund made for the purposes of determining the future pension charges in the accounts of the group. These results revealed the fund to be in surplus to an amount of approximately £600 million, with assets of the fund at £19,879 million covering 103% of the fund's liabilities, in contrast to an asset coverage of 97% at 31 December 1993. The surplus principally arose from the return on the fund's assets in the three intervening years being higher than the long-term actuarial assumptions.

The major assumptions used in the December 1996 valuation were that, over the long-term, the return on the existing assets of the fund, relative to market values, would be 8.2% per annum and on future investments the return would be 8.7% per annum (allowing for real equity dividend growth of 0.5% per annum), the retail price index would increase at an average of 4.0%, and wages and salary rates would increase at an average of 5.8%.

From 1 April 1997, the annual pension charge based on the December 1996 valuation is expected to be lower than the charge of £291 million in the year to 31 March 1997. This revised charge will take into account the amount of the pension provision which has been established over the past eight years in the group's accounts and which stood at £1,291 million at 31 March 1997. Additionally, from 1 April 1997, in accordance with current UK accounting standards, the cost of providing incremental pension benefits for early leavers will no longer be charged against the profit in the period in which people leave, whilst the most recent valuation shows the fund to be in surplus.

BT expects to continue making cash contributions to its fund at broadly the current level of 9.5% of pay in order to maintain the fund's financial strength.

Merger with MCI

The proposed merger with MCI, having been approved by both BT and MCI shareholders, is now awaiting regulatory approval. On completion, which is expected in the autumn of 1997, BT will change its name to Concert plc and issue, in the form of American Depositary Shares (“ADSs”), 5.4 ordinary shares in the company and \$6 cash for every MCI share outstanding, except those already owned by BT or subject to dissenters’ rights. Each ADS represents 10 ordinary shares of the company and will be traded on the New York Stock Exchange. Options over Concert shares will be issued to MCI share option holders who do not exercise their MCI options before the completion date using similar conversion terms. As a result of the merger, the company’s issued share capital will be enlarged by approximately 50% and the cash consideration is expected to total between £2.0 billion and £2.3 billion, depending primarily on the number of MCI share options exercised before completion.

Following the merger and based on MCI’s revenues for 1996, the group’s annual turnover is expected to increase by around 80%. Earnings per share of the enlarged group are expected, however, to suffer some dilution in the first year after the merger.

The directors of BT and MCI are targeting pre-tax synergy benefits arising from the full integration of the two businesses at approximately £1.5 billion cumulatively over five years following the merger. No significant capital expenditure is expected to be required to realise these savings, although some one-off restructuring costs are expected to be incurred in the first few years following the merger.

If market conditions are appropriate, the company will consider making purchases of its own shares following the merger and in ensuing years. Authority to purchase up to 10% of the company’s share capital was granted to the directors at the extraordinary general meeting of shareholders held in April 1997. Decisions on the amount of cash to be used in buying back shares and the precise timing will depend in part on market conditions and other opportunities that exist for the deployment of the group’s resources.

Foreign currency exposure

Most of the group’s current turnover is invoiced in pounds sterling, and most of its operations and costs arise within the UK. The group’s foreign currency borrowings, which totalled £1,053 million at 31 March 1997, are used to finance its UK operations and to finance the group’s overseas investments, including MCI, in order to reduce the currency exposure on the underlying assets. Cross currency swaps have been entered into to minimise the foreign currency exposure on the borrowings used to finance the group’s operations. The group also enters into forward foreign exchange contracts to hedge interest expense, purchase and sale commitments. The commitments hedged are principally US dollars. As a result of these policies, the group’s exposure to foreign currency arises mainly on the residual currency exposure on overseas investments and on any imbalances between the value of outgoing, transit and incoming international calls with overseas telecommunication operators. To date, these imbalances have not been material. As a result, the group’s profit has not been materially affected by movements in exchange rates.

The merger with MCI will naturally lead to an increase in the group’s foreign currency exposure in the future and the company will be adopting suitable policies and procedures on completion of the merger to manage this change in circumstances.