

Financial review

Please see cautionary statement regarding forward-looking statements on page 140.

Introduction

The 2002 financial year has been dominated by a series of corporate transactions designed to focus and transform the group and reduce its net debt position.

During the 2002 financial year, we reduced our net debt by £14.2 billion to £13.7 billion at 31 March 2002, better than the target of £15 billion to £20 billion we set ourselves in May 2001. We raised £5.9 billion through the rights issue which closed in June 2001, sold our Japanese telecoms and Spanish mobile phone investments for £4.8 billion, sold the Yell directories business for approximately £2 billion and sold and leased back our properties for £2.4 billion. We also announced the unwind of the Concert joint venture and exit from AT&T Canada, which were subsequently completed on 1 April 2002.

In May 2001, we announced a three for ten rights issue at a price of 300 pence per share. The rights issue, which closed on 15 June 2001, raised approximately £5.9 billion, net of expenses. Earnings (loss) and dividends per share figures in this document have been restated for the dilutionary effect of the rights issue.

The comparative figures for 2001 and 2000 have been restated to reflect the implementation of FRS 19 "Deferred tax".

In this Financial review the commentary is focused principally on the results of the continuing activities of BT Group.

Demerger and capital reduction

The demerger of mmO2, the group's former mobile phone business, was successfully completed on 19 November

2001 after being announced in May 2001. The demerger followed meetings held in October 2001, at which BT shareholders voted in favour of the scheme of arrangement and demerger of mmO2 to create two new listed companies and also voted in favour of the BT Group reduction of capital. The scheme of arrangement and reduction of capital were subsequently approved by the High Court. The demerger became effective on 19 November 2001 and the reduction of capital on 21 November 2001. Dealings in BT Group and mmO2 shares commenced on 19 November 2001. BT shareholders on record on 16 November 2001, received one BT Group plc share and one mmO2 plc share for each existing British Telecommunications plc share held. Based on the first day's dealings on the London Stock Exchange, BT Group represented approximately 78% of the equity value of the former BT group and mmO2 represented approximately 22%.

On the demerger, net assets of £19,490 million attributable to mmO2 were distributed to shareholders in the form of a demerger distribution. mmO2 assumed approximately £500 million of debt, with the bulk of the outstanding debt remaining with the continuing BT Group. The reduction of capital had the effect of increasing distributable reserves in BT Group plc by £9,537 million. As a consequence, the group balance sheet has changed significantly and is discussed later in this review.

Introduction to the financial results

The following table shows the summarised profit and loss account which is discussed further on the following pages. The operating results by line of business are discussed first, followed by the overall group results.

Summarised profit and loss account

	2002		2001		2000	
	Continuing activities £m	Total £m	Continuing activities £m	Total £m	Continuing activities £m	Total £m
Total turnover	21,815	24,642	21,068	29,666	18,228	21,903
Group's share of associates' and joint ventures' turnover	(4,049)	(4,764)	(4,625)	(9,937)	(2,279)	(3,364)
Trading between group and principal joint venture	681	681	698	698	176	176
Group turnover	18,447	20,559	17,141	20,427	16,125	18,715
Other operating income	361	362	346	359	216	216
Operating costs	(18,854)	(21,400)	(14,500)	(20,759)	(12,985)	(15,359)
Group operating profit (loss):						
Before goodwill amortisation and exceptional items	2,771	2,580	3,082	3,257	3,430	3,772
Goodwill amortisation and exceptional items	(2,817)	(3,059)	(95)	(3,230)	(74)	(200)
	(46)	(479)	2,987	27	3,356	3,572
Group's share of operating loss of associates and joint ventures	(1,443)	(1,381)	(531)	(397)	(213)	(400)
Total operating profit (loss):						
Before goodwill amortisation and exceptional items	2,663	2,546	2,925	3,377	3,274	3,456
Goodwill amortisation and exceptional items	(4,152)	(4,406)	(469)	(3,747)	(131)	(284)
	(1,489)	(1,860)	2,456	(370)	3,143	3,172
Profit on sale of fixed asset investments and group undertakings	21	4,389	618	619	126	126
Profit on sale of property fixed assets	1,089	1,089	34	34	26	26
Amounts written off investments	(535)	(535)	–	–	–	–
Net interest payable	(1,579)	(1,622)	(1,171)	(1,314)	(327)	(382)
Profit (loss) on ordinary activities before taxation:						
Before goodwill amortisation, exceptional items and taxation	1,273	1,113	1,763	2,072	2,973	3,100
Goodwill amortisation and exceptional items	(3,766)	348	174	(3,103)	(5)	(158)
	(2,493)	1,461	1,937	(1,031)	2,968	2,942
Taxation	(385)	(443)	(432)	(712)	(864)	(957)
Profit (loss) after taxation	(2,878)	1,018	1,505	(1,743)	2,104	1,985
Minority interests	(10)	(23)	2	(127)	9	10
Profit (loss) for the financial year	(2,888)	995	1,507	(1,870)	2,113	1,995
Basic earnings (loss) per share	(34.8)p	12.0p	20.7p	(25.7p)	29.2p	27.6p
Basic earnings per share before goodwill amortisation and exceptional items	8.8p	6.1p	19.3p	17.5p	29.5p	29.8p

Lines of business results

In the following commentary, we discuss the operating results of the group for the 2002 and 2001 financial years in terms of the lines of business established during the 2001 financial year. Elements of the information for the 2001 financial year have been restated to show the businesses as if they had traded as separate units throughout the relevant period. However, as it is not practical for us to compile comparative figures for the 2000 financial year for the lines of business, this earlier year is discussed in the context of the overall group results.

Line of business summary

	Group turnover		Group operating profit (loss) before goodwill amortisation and exceptional items	
	2002 £m	2001 £m	2002 £m	2001 £m
BT Retail	12,085	12,063	1,102	888
BT Wholesale	12,256	11,728	2,242	2,538
BT Ignite	4,476	3,468	(353)	(309)
BTopenworld	222	140	(118)	(233)
Other	373	138	(102)	198
Intra-group	(10,965)	(10,396)	–	–
Total continuing activities	18,447	17,141	2,771	3,082
Discontinued activities	2,112	3,286	(191)	175
Group totals	20,559	20,427	2,580	3,257

The group's profits from continuing activities are derived predominantly from BT Retail and BT Wholesale's fixed network business in the UK. BT Ignite and BTopenworld are both in a development stage and incurring losses. The discontinued activities comprise mmO2, Yell, Japan Telecom, J-Phone and Airtel.

mmO2's activities up to the demerger in November 2001 comprised principally the group's controlled mobile activities in the UK, Germany, the Republic of Ireland and the Netherlands, and the Genie mobile internet business. The profit from mmO2's mobile network in the UK was offset by losses being incurred in establishing its networks in Germany, the Republic of Ireland and the Netherlands. Until its sale in June 2001, Yell contributed a profit principally from its Yellow Pages directory activities in the UK.

BT Retail	2002	2001
	£m	£m
Group turnover	12,085	12,063
Gross margin	3,399	3,443
Sales, general and administration costs	2,097	2,371
EBITDA	1,302	1,072
Operating profit	1,102	888
Capital expenditure	143	157
Operating free cash flow	1,159	915

Note – before goodwill amortisation and exceptional items.

BT Retail's results have benefited in the 2002 financial year from the strategic focus on defending core revenues and gross margins, cost reduction through a series of cost transformation programmes and positioning BT Retail to grow top line revenue through new wave revenues.

Turnover in the 2002 financial year at £12,085 million was virtually unchanged on the previous year. Initiatives such as BT Answer 1571 and BT Together fixed price packages, together with increased focus on business customers, have contributed to stemming the decline in turnover. As a result of changes required by Oftel, partial private circuits used by UK fixed network operators are no longer provided by BT Retail, but are provided as a BT Wholesale product. This has reduced revenue by £90 million in BT Retail.

Gross margin at £3,399 million declined in the 2002 financial year and was 28.1% of turnover compared with 28.5% in the 2001 financial year.

Cost transformation has produced a total saving of £274 million (12%) in selling, general and administration costs, excluding exceptional items, over the year. These cost savings have contributed towards the EBITDA growth in the year of £230 million (21%). This has also enabled BT Retail to contribute an operating free cash flow (EBITDA less capital expenditure) of £1,159 million in the year which is £244 million (27%) better than the 2001 financial year. In addition, BT Retail generated £170 million cash inflow as a result of an improvement in stock and debtors during the year.

The number of employees in BT Retail at 31 March 2002 at 50,800 was approximately 5% lower than at 31 March 2001.

BT Retail launched the Next Generation Contact Centre Programme, which will rationalise the number of call centres from 104 sites to 30 over the next two years. The associated exceptional costs of £68 million are discussed on page 34.

BT Retail provides an end to end service to its customers over 28.3 million lines in the UK. BT Retail's turnover is mainly derived from calls, lines, private services and total business solutions to the consumer, SME and major business markets.

BT Retail has undertaken a number of pricing and other initiatives, which has resulted in the slowing down of the estimated loss of market share. Within the residential voice market, BT Retail maintained market share, as it has done since June 2000, with share internally estimated at 73%. In the business voice market, internal estimates put BT Retail's share at 48%, down 3% in the year against a 4.5% fall in the prior year. Within the Dial IP market, BT Retail continues to gain market share in both business and residential sectors, with an estimated total share of 75%, up 8% in the year.

Turnover for the year is summarised as follows:

BT Retail turnover	2002	2001
	£m	£m
Fixed network calls	4,691	4,963
Exchange lines	3,617	3,398
Customer premises equipment supply	605	609
Private services	559	616
Other sales and services	1,048	1,078
Total external sales ^a	10,520	10,664
Sales to other BT businesses	1,565	1,399
Total	12,085	12,063

^aExternal sales include sales to mmO2 for both years under review.

Turnover from fixed network calls declined by 5% to £4,691 million compared to the 2001 financial year following a decline of 4% in the 2001 financial year. Fixed network calls comprise all calls made by customers on the BT fixed line network in the UK, including outbound international calls, calls to mobile phones and calls to the internet.

Absolute call volumes in BT Retail increased by 6% following growth of 8% in both the 2001 and 2000 financial years.

The year saw the stemming of the rate of decline of inland geographic call volumes driven by initiatives such as BT Together, with unlimited local and UK calls, Chataway weekends and updates of the 1571 services. Total geographic call volume decreased by 6% in the 2002 financial year compared to 10% in the prior year.

Following rapid growth of 60% in the 2001 financial year, internet related and other non-geographic growth has stabilised in the fourth quarter of the 2002 financial year to give overall growth of 24% for the year as customers switch to FRIACO (Flat Rate Internet Access Call Origination) based internet products. FRIACO is not a BT Retail product and accordingly, not reflected in the BT Retail call volumes. The

growth in fixed to mobile calls of 10%, compares to 32% in the 2001 financial year, primarily due to the slowing growth in mobile handsets and the introduction of BT Talk Together, encouraging customers to call fixed lines rather than mobiles.

The increase in the level of FRIACO based call volumes has been the main reason for the overall BT Group call volumes growth of 19% in the 2002 financial year and 18% in the 2001 financial year.

Overall, turnover from exchange lines grew by 6% in the 2002 financial year to £3,617 million after increasing by 4% in the 2001 financial year. Changes in prices and supplier costs together with volume growth in both the residential and business sectors has improved gross margins for this product.

The number of BT Retail business lines grew by 1.5% in the 2002 financial year and by 5% in the 2001 financial year, with high speed ISDN services being the main driver behind this growth. The number of residential lines increased marginally (by 0.3%) in the 2002 financial year due to the success of the BT Together packages, and customers returning to BT. This compares to a marginal decline in the 2001 financial year. Residential primary lines increased by 42,000 lines over the year with much of this attributed to the success of our overall approach in attracting and retaining customers. Overall BT Retail's total fixed network lines grew by 1% to 28.3 million in the 2002 financial year.

Sales to other BT businesses grew by £166 million (12%) in the 2002 financial year, benefiting from the growing revenues from data and solutions products provided by BT Ignite Solutions to major business customers.

BT Wholesale

	2002 £m	2001 £m
Group turnover	12,256	11,728
EBITDA	4,156	4,276
Operating profit	2,242	2,538
Capital expenditure	1,974	2,273
Operating free cash flow	2,182	2,003

Note – before goodwill amortisation and exceptional items

BT Wholesale maintained its strong cash generation capability with an operating free cash flow (EBITDA less capital expenditure) of £2,182 million, £179 million higher than in the 2001 financial year.

The majority of BT Wholesale's turnover (68%) is internal to BT Group and derived from supplying network services, mainly to BT Retail. External turnover is derived from providing wholesale products and solutions to other operators, including Concert and mmO2, interconnecting with BT's UK fixed network.

Turnover in the 2002 financial year totalled £12,256 million, an increase of 5% on the prior year. Network volume growth of 8% was partly offset by a 3% decrease due to price and mix.

External turnover grew by 19% in the 2002 financial year to £3,911 million; excluding sales to Concert, external

turnover grew by 24%. New business revenues, including broadband and solutions, at £102 million were 240% higher than last year and FRIACO contributed revenues of £68 million in the 2002 financial year.

However, the impact of price reductions, due to flat rate price packages and Oftel determinations, and the volume effects of unfavourable market conditions in the 2002 financial year have slowed the rate of growth of transit and conveyance revenues.

Low margin transit revenues have been affected by the slow down in the mobile market and the TMT sector during the fourth quarter, but at £1,405 million were 27% higher in the 2002 financial year. Turnover from conveyance traffic was virtually unchanged year on year as a result of FRIACO substitution of internet traffic, stabilisation in other network operators' market share and the Oftel Number Translation Service price determination.

Revenues from partial private circuits which began in August 2001, totalled £56 million in the year and substituted higher priced retail private circuits.

Internal turnover decreased by 1% to £8,345 million. Other reductions in network charges were offset by a 5% increase in payments to other operators recharged to BT Retail.

BT Wholesale's operating costs, excluding depreciation, rose by 9% to £8,355 million in the 2002 financial year. The principal reasons for this are discussed below.

Interconnect payments to other network operators increased by 11% to £3,849 million. These costs are mainly recharged to BT Retail with no margin or as transit revenues with minimal margins.

Net staff costs increased by £91 million to £686 million with early leaver costs of £23 million and a change in the mix of capital and current work.

Payments to other BT lines of business increased by £201 million to £3,429 million. This was mainly due to an increase in payments to BT Retail for field engineering services, cost of sales of BT Retail's products and an increase in payments to BT Ignite for broadband services, offset by reductions in other group charges.

In addition to an exceptional bad debt charge of £79 million, referred to later, the bad and doubtful debt costs before exceptional items were £47 million compared to £15 million last year.

Excluding payments to other network operators and the bad and doubtful debt costs, the operating cost increase was 7%, compared to network volume growth of 8%.

Depreciation costs rose by 10% to £1,914 million as a result of the effect of a reduction in the assumed asset lives resulting from the adoption of new technology, higher capital expenditure in the 2001 financial year and broadband investment.

Operating profit at £2,242 million was £296 million lower than the 2001 financial year. EBITDA at £4,156 million was £120 million down on the 2001 financial year. EBITDA margin of 34% was lower than the 36% margin achieved in the 2001 financial year.

Capital expenditure on plant and equipment at £1,974 million in the 2002 financial year was 13% lower than the prior year, reflecting continued tight control of investment.

BT Ignite	2002 £m	2001 £m
Group turnover	4,476	3,468
EBITDA	146	50
Group operating loss	(353)	(309)
Share of losses of associates and joint ventures	(38)	(121)
Capital expenditure	609	935
Operating free cash flow	(463)	(885)

Note – before goodwill amortisation and exceptional items

BT Ignite's group turnover was £4,476 million for the 2002 financial year, an increase of 29%. Excluding the effect of acquisitions and disposals, the growth in turnover was 18%. This underlying increase was mainly driven by the growth of Solutions, European Connectivity and UK IP revenues.

Ignite Solutions turnover grew by 17% to £1,828 million in the 2002 financial year. Against a backdrop of difficult market conditions, Syntegra, BT Ignite's systems integration business, grew turnover by 8% to £609 million.

Turnover from European Connectivity grew by £527 million to £998 million in the 2002 financial year, reflecting the acquisition of BT Ignite GmbH in Germany in February 2001. Turnover from UK IP and other operations increased by 29% to £1,024 million.

EBITDA improved by £96 million to £146 million for the 2002 financial year. Included in these results were early leaver costs of £55 million compared to £8 million in the 2001 financial year. Headcount was reduced by 2,400 from 18,800 at 31 March 2001 to 16,400 at 31 March 2002.

The share of losses in BT Ignite's associates and joint ventures improved by £83 million to £38 million in the 2002 financial year, mainly due to the change in status of BT Ignite's associates in Germany and the Netherlands to wholly-owned subsidiaries following the purchase of the remaining shares in the 2001 financial year. There were also lower losses in Albacom, BT Ignite's Italian joint venture.

BT Ignite's group operating loss before goodwill amortisation and exceptional items increased by £44 million to £353 million in the 2002 financial year.

BT Ignite's capital expenditure for the year was £609 million in the 2002 financial year, a reduction of £326 million on the prior year, reflecting the focus on cash control.

BTopenworld	2002 £m	2001 £m
Group turnover	222	140
EBITDA	(102)	(198)
Group operating loss	(118)	(233)
Share of losses of associates and joint ventures	(7)	(59)
Capital expenditure	10	10
Operating free cash flow	(112)	(208)

Note – before goodwill amortisation and exceptional items

BTopenworld's group turnover is derived principally from its UK broadband and narrowband internet access services. Turnover for the 2002 financial year was £222 million, an increase of 59% on the prior year. This turnover growth is due to the new broadband product range introduced in 2001 as well as growth in the existing narrowband product range.

The total number of UK internet service provider customers of BTopenworld (excluding those served via virtual ISPs) at 31 March 2002 was approximately 1.75 million, representing annual growth of 40%. With over one million customers on unmetered packages at 31 March 2002, BTopenworld is one of the leading unmetered internet access providers in the UK.

EBITDA loss for the 2002 financial year was £102 million, a 48% improvement on the prior year.

Comparison of the 2002 financial year's results with those of the 2001 and 2000 financial years

Group turnover

Group turnover from continuing activities, excluding BT's share of the ventures' turnover, grew by 8% to £18,447 million in the 2002 financial year compared to growth of 6% in the 2001 financial year.

Turnover from discontinued activities includes the results of mmO2, demerged on 19 November 2001, Japan Telecom and J-Phone Communications, sold in June and July 2001, and Yell, sold on 22 June 2001.

Total group turnover, excluding BT's share of the ventures' turnover, increased marginally by 0.6% in the 2002 financial year to £20,559 million after growth of 9% in the 2001 financial year. The increase in turnover from continuing activities was offset by the decline in turnover from discontinued activities. The group's turnover by product is analysed as follows:

Group turnover	2002 £m	2001 £m	2000 £m
Fixed-network calls	5,266	5,655	5,908
Exchange lines	3,926	3,674	3,526
Receipts from other operators	3,113	2,814	1,974
Private services	1,039	1,091	1,135
Solutions	1,661	1,074	915
Customer premises equipment supply	688	726	847
Other sales and services	2,754	2,107	1,820
Continuing activities	18,447	17,141	16,125
Discontinued activities and intra-group	2,112	3,286	2,590
Group turnover	20,559	20,427	18,715

Turnover from fixed-network calls declined by 7% to £5,266 million in the 2002 financial year compared to a decline of 4% to £5,655 million in the 2001 financial year. Fixed-network calls comprise all calls by customers made from fixed lines in the UK, including outbound international calls. In the 2002 and 2001 financial years, call volume growth

was more than offset by the effect of significant price reductions.

Turnover from exchange lines grew by 7% to £3,926 million in the 2002 financial year after growth of 4% in the 2001 financial year to £3,674 million. The number of business lines grew by 1.3% and 5% in the 2002 and 2001 financial years, with high speed ISDN services being the main driver behind this growth. The number of residential lines has been broadly flat during the period under review. Competition from other fixed line providers has largely been offset by the success of the BT Together packages and customers returning to BT. Overall, BT's total fixed-network lines grew by 0.6% to 29.1 million in the 2002 financial year after growth of 1.3% in the 2001 financial year.

Turnover from receipts from other operators for interconnect charges increased by 11% to £3,113 million in the 2002 financial year compared to 43% growth in the 2001 financial year, reflecting the reduced growth in interconnect volumes. This turnover mainly comprises the income BT generates from other UK operators for passing calls from one operator to another and for terminating calls on BT's network. In the 2000 financial year, it also included receipts from international operators for incoming international and transit calls which BT received before this activity was transferred to Concert in early January 2000. From that date, this turnover includes receipts from Concert for terminating incoming calls into the UK and handling Concert's UK multinational customer domestic traffic. The increase in turnover, in the 2002 and 2001 financial years, primarily reflects the growing market share of BT's UK competitors, particularly mobile phone operators, and the increasing level of traffic flowing through and into BT from their networks. There has been a large corresponding increase in the payments made by BT to these operators for traffic passing to their networks. Although growth has been rapid, with volumes growing at 12% and 50% for the 2002 and 2001 financial years, BT Wholesale's interconnect business does not provide the group with the same overall level of margin as its UK retail business.

Private services turnover decreased by 5% to £1,039 million in the 2002 financial year after declining by 4% in the 2001 financial year.

Turnover from the external sales outsourcing and systems integration services grew by 55% to £1,661 million in the 2002 financial year after growth of 17% in the 2001 financial year.

Turnover from BT's other sales and services has grown by 31% to £2,754 million in the 2002 financial year after growth of 16% in the 2001 financial year. The increase includes the results of the BT Ignite European Connectivity and UK IP revenues.

Total turnover

Total turnover from continuing activities in the 2002 financial year of £21,815 million includes BT's proportionate share of its ventures' turnover of £4,049 million before adjusting for trading between the Concert joint venture and the BT

group. This total turnover grew by 4% in the 2002 financial year after growing by 16% in the 2001 financial year.

Other operating income

As part of the arrangements for the establishment of Concert, BT had been seconding staff and providing administrative and other services from its launch in early January 2000. The income from these services totalled £135 million in the 2002 financial year, £168 million in the 2001 financial year and £79 million in the 2000 financial year.

Operating costs

Total operating costs from continuing activities increased by 30% in the 2002 financial year to £18,854 million after increasing by 12% in the 2001 financial year. As a percentage of group turnover from continuing activities, operating costs from continuing activities, excluding goodwill amortisation and exceptional items, increased from 80% in the 2000 financial year to 84% in the 2001 financial year and to 87% in the 2002 financial year. In all three financial years, net exceptional costs were incurred. These amounted to £2,696 million, £7 million and £64 million in the 2002, 2001 and 2000 financial years, respectively. These exceptional costs are considered separately in the discussion which follows.

Operating costs	2002 £m	2001 £m	2000 £m
Continuing activities:			
Staff costs	4,260	4,069	3,959
Own work capitalised	(623)	(642)	(475)
Depreciation	2,974	2,689	2,446
Goodwill and other intangibles amortisation	124	91	10
Payments to telecommunications operators	4,289	3,736	2,992
Other operating costs	5,134	4,550	3,989
Total operating costs from continuing activities before exceptional costs	16,158	14,493	12,921
Exceptional costs	2,696	7	64
Total operating costs from continuing activities	18,854	14,500	12,985
Total operating costs from discontinued activities	2,546	6,259	2,374
Total operating costs	21,400	20,759	15,359

Staff costs increased by 5% in the 2002 financial year to £4,260 million after increasing by 3% in the 2001 financial year. In the 2002 financial year, the numbers employed in the continuing activities decreased by 8,200 to 108,600 at 31 March 2002 after decreasing by 4,000 in the 2001 financial year. Higher pension costs and the annual pay awards were the main reasons for the increase in staff costs.

The allocation for employee share ownership, included within staff costs, was £25 million in the 2002 financial year. The allocation for the 2001 financial year was £32 million.

Early leaver costs, before exceptional items, of £191 million were incurred in the 2002 financial year, compared with £118 million in the 2001 financial year and £59 million in the 2000 financial year. This reflects BT's continued focus on reducing headcount and improving operational efficiencies. In view of a pension fund accounting surplus, which for accounting purposes includes any provision for pension costs in the group's balance sheet, and in accordance with BT's accounting policies, early leaver charges for the two financial years 2001 and 2000 do not include the costs of the incremental pension benefits provided to early leavers, which totalled £429 million and £140 million, respectively. In the 2002 financial year £140 million of the cost of incremental pension benefits was charged against the pension fund accounting surplus, to the extent available, and the balance of £21 million was charged to the profit and loss account. Under the NewStart programme launched in the fourth quarter of 2001, BT employees who leave in advance of normal retirement age receive a leaving payment rather than a redundancy payment and the incremental pension benefits have been scaled down. This should reduce the future level of early leaver costs.

The depreciation charge increased by 11% in the 2002 financial year to £2,974 million after increasing by 10% in the 2001 financial year, a reduction in the assumed asset lives, reflecting BT's continuing high level of investment in its networks and broadband investment.

Goodwill amortisation in respect of subsidiaries and businesses acquired since 1 April 1998, when BT adopted FRS 10, and amortisation of other intangibles amounted to £124 million in the 2002 financial year compared with £91 million in the 2001 financial year and £10 million in the 2000 financial year.

Payments to other telecommunication operators grew by 15% in the 2002 financial year to £4,289 million after increasing by 25% in the 2001 financial year. The growth in these payments reflects the growing number of calls originating on or passing through BT's networks and terminating on UK competitors' fixed and mobile networks. This is due, in particular, to the increase in mobile phone usage and internet-related calls. The payments include those made to Concert for the delivery of BT's outgoing international calls from early January 2000 and those made by BT to international operators for outgoing and transit calls prior to that time.

Other operating costs, which rose by 13% in the 2002 financial year to £5,134 million after increasing by 14% in the 2001 financial year, include the maintenance and support of the networks, accommodation and marketing costs, the cost of sales of customer premises equipment and redundancy costs.

The exceptional items within operating costs from continuing activities for the 2002 financial year totalled £2,696 million and are shown in the table below.

Exceptional operating costs	2002 £m	2001 £m	2000 £m
Impairment of goodwill and tangible fixed assets of BT Ignite European activities	2,202	200	–
Concert unwind costs	172	–	–
BT Retail call centre rationalisation	68	–	–
BT Wholesale bad debt expense	79	–	–
mmO2 demerger costs	98	–	–
Other	77	(193)	64
Total attributable to continuing activities	2,696	7	64
Total attributable to discontinued activities	11	2,850	47
Total exceptional operating costs	2,707	2,857	111

The most significant item in the 2002 financial year was the impairment of goodwill and tangible fixed assets in BT Ignite's European activities. In the light of our announcement that BT Ignite was streamlining its activities to focus on multi-site corporate customers with European activities and the assimilation of BT's share of Concert's activities, an impairment review of BT Ignite's investment in its European activities was performed. As a result, a goodwill impairment charge of £1,939 million and a tangible fixed asset impairment charge of £263 million has been recognised. The goodwill in BT Ignite's European activities has been fully written down.

Exceptional items within operating costs in the 2002 financial year also include:

- costs of £172 million associated with the unwind of the Concert global venture, discussed further on page 36;
- charges of £68 million in relation to the BT Retail call centre rationalisation programme, reducing the number of call centres from 104 to 30 over the next two years. In addition, unprovided costs of £50 million are expected to be incurred in future years;
- bad debt charges of £79 million, in BT Wholesale, as a result of severe liquidity problems in the TMT sector during the latter part of the year, in addition to increased bad debt charges taken through normal operating activities;
- costs of £98 million associated with the demerger of mmO2; and
- other charges of £77 million including impairment of payphone assets.

The most significant item in the 2001 financial year was the impairment of goodwill in Viag Interkom. The acquisition of the 55% interest in the company was completed for £8,770 million in February 2001 and goodwill of £4,992 million arose on this transaction. The impairment review

resulted in an impairment in goodwill of £3,000 million, of which £200 million related to BT's continuing activities.

Other exceptional items within operating costs in the 2001 financial year included a credit of £193 million for the refund of rates on BT's infrastructure following a successful legal action taken by BT in 2000 to challenge the rateable valuations on which it was charged for its network assets.

In the 2000 financial year, there were exceptional costs of £64 million involved in the work to ensure that BT's business became fully independent of MCI Communications, a former associated company. In addition there were £47 million costs for the exit of BT Cellnet's analogue network in the 2000 financial year.

Group operating profit (loss)

In the 2002 financial year, group operating profit from continuing activities before goodwill amortisation and the exceptional items, described above, of £2,771 million was 10% lower than in the 2001 financial year, which in turn was 10% lower than in the 2000 financial year.

Total group operating loss for the 2002 financial year was £479 million compared to a profit of £27 million in the 2001 financial year and £3,572 million in the 2000 financial year.

Associates and joint ventures

The results of associates and joint ventures between continuing and discontinued activities are shown below:

	2002 £m	2001 £m	2000 £m
Share of turnover			
Continuing activities	4,049	4,625	2,279
Discontinued activities	715	5,312	1,085
Total	4,764	9,937	3,364
Share of operating profit (loss) before exceptional items and goodwill amortisation			
Continuing activities	(108)	(157)	(156)
Discontinued activities	74	277	(160)
Total	(34)	120	(316)

After the disposals in the 2001 and 2002 financial years, BT's share of its ventures' turnover fell to £4,764 million in the 2002 financial year from £9,937 million in the 2001 financial year. The growth in the 2001 financial year was due to our establishment and acquisition of interests in ventures in North America, Europe and Asia Pacific, many of which have now been sold, terminated or unwound. Acquisitions of interests contributed £6,133 million of the growth in the 2001 financial year. In the 2002 financial year, £4,618 million of the total arose from ventures located outside the UK, compared with £9,677 million in the 2001 financial year and £3,164 million in the 2000 financial year.

The principal contributors to turnover from continuing activities in the 2002 financial year were Concert (£2,158 million), Cegetel in France (£1,068 million) and LG Telecom in Korea (£240 million). The principal

contributors to turnover in the 2001 financial year were Concert (£2,576 million), Cegetel (£860 million) and LG Telecom (£281 million). The main contributors in the 2000 financial year were Cegetel (£727 million), Concert (£583 million from January 2000) and a full year's contribution from LG Telecom (£200 million).

The principal contributors to turnover from discontinued activities in the 2002 financial year were Japan Telecom and J-Phone (£559 million to June 2001) and Airtel (£76 million to June 2001). The principal contributors to turnover from discontinued activities in the 2001 financial year were Japan Telecom and J-Phone (£4,542 million), and Airtel (£286 million). The main contributors in the 2000 financial year were Japan Telecom (£501 million from September 1999), and Airtel (£250 million).

The group's share of its ventures' operating losses from continuing activities totalled £108 million in the 2002 financial year, before £1,335 million goodwill amortisation and exceptional items. The comparable losses, before goodwill amortisation and exceptional items, amounted to £157 million and £156 million in the 2001 and 2000 financial years, respectively.

The principal contributor to the group's share of operating losses from continuing activities before goodwill amortisation and exceptional items in the 2002 financial year was Concert (£225 million) offset by profits from Cegetel (£168 million). In the 2001 financial year Concert reported profits of £19 million and Cegetel of £90 million, offset by losses in other ventures. The main contributors to the loss in the 2000 financial year was BiB (British Interactive Broadcasting) (£89 million) offset by profits from Concert (£69 million from January 2000) and Cegetel (£30 million).

Exceptional items within the operating profits from ventures are as follows:

	2002 £m	2001 £m	2000 £m
Impairment of Concert	806	–	–
Concert unwind costs	81	–	–
Impairment of investments and related exit costs	234	–	–
Goodwill impairment	173	200	–
Subscriber acquisition costs	–	96	–
Total attributable to continuing activities	1,294	296	–
Total attributable to discontinued activities	–	36	–
Total exceptional operating costs	1,294	332	–

Concert's performance was a cause of concern in 2001 and in October 2001 BT and AT&T announced the unwind of Concert which was subsequently completed on 1 April 2002. On completion, the businesses, customer accounts and networks returned to the two parent companies with BT and AT&T each taking ownership of substantially those parts of Concert originally contributed by them. The working capital and other liabilities of Concert on completion were

divided equally between BT and AT&T with the exception that BT receives an additional US\$400 million reflecting the allocation of the businesses. Of this, US\$50 million was received before 31 March 2002, US\$161 million has subsequently been received and the balance is expected to be received in autumn 2002.

BT and AT&T have also, at completion, terminated their Canadian joint venture agreement under which BT was committed to participate in AT&T's future obligation to acquire all of the publicly traded shares of AT&T Canada. AT&T has taken full ownership of BT's interest in the Canadian joint venture and in AT&T Canada, and has now assumed full responsibility for all future obligations of the joint venture. BT has now ceased to have any interest in AT&T Canada, and has been released from its future expenditure commitment associated with AT&T Canada.

As a result, BT has written down the carrying value of its investments in both Concert and AT&T Canada in the 2002 financial year. The exceptional impairment charge of £1,153 million against these investments comprises Concert goodwill impairment of £260 million, Concert tangible fixed asset write-downs of £546 million and the write off of BT's £347 million interest in AT&T Canada (included within amounts written off investments).

BT has recognised exceptional restructuring charges of £81 million for its share of redundancy and other unwind costs in Concert and BT's own unwind costs of £172 million have been charged against group operating costs in the 2002 financial year.

The value of BT's investments has been reviewed in the light of the rapidly changing global telecoms market conditions. In addition we have estimated the costs to exit certain investments. Exceptional impairment charges and related exit costs totalling £407 million, principally relate to goodwill and asset impairments in Blu and SmarTone.

In the 2001 financial year there was an exceptional write off of previously capitalised costs in certain non-UK operations related to deferred subscriber acquisition costs in the ventures. In addition goodwill in Asian ventures became impaired and an exceptional impairment charge of £200 million was recognised.

Goodwill amortisation had been increasing as a result of new acquisitions in ventures. In the 2001 financial year, the charge totalled £185 million compared with £84 million in the 2000 financial year. This trend has not continued in the 2002 financial year because we have not made any major acquisitions of interests in ventures since May 2000, the effect of the goodwill impairment in the 2001 financial year of £200 million and we have now sold or acquired control of many of these ventures. Goodwill amortisation in the 2002 financial year amounted to £53 million.

Total operating profit (loss)

Total operating profit from continuing activities before goodwill amortisation and exceptional items for the 2002 financial year was 9% lower than that in the 2001 financial year which in turn was 11% lower than the previous

financial year. The decline in the underlying total operating profit was due to the factors explained above.

Total operating loss for the 2002 financial year was £1,860 million, including BT's share of the operating results of its ventures. This increased loss of £1,490 million against the 2001 financial year reflects the reduced operating profit from continuing activities including the exceptional charges and is offset by the reduced losses in discontinued activities. The loss for the 2001 financial year compared with a profit of £3,172 million for the 2000 financial year principally due to the £3,200 million goodwill impairment charges.

Profit on sale of group undertakings and fixed asset investments

A major feature of the 2002 financial year was the successful disposal of non-core businesses as part of our drive to reduce our net debt. The consideration for these disposals totalled £8.0 billion and £6.9 billion was received in cash in the year. The profit before taxation from the disposals totalled £4,389 million as shown in the following table.

Disposals	Consideration £m	Profit (loss) before tax £m
Japan Telecom and J-Phone Communications	3,709	2,358
Yell	1,960	1,128
Airtel	1,084	844
Maxis Communications Berhard	350	(4)
Rogers Wireless Communications	267	(23)
BiB	241	120
Clear Communications	119	(126)
e-peopleserve	70	61
Other	173	31
Total	7,973	4,389

BT completed the sale to Vodafone of its 20% economic interest in Japan Telecom and its 20% interest in J-Phone Communications on 1 June 2001 and subsequently its interest in J-Phone group companies. The total proceeds of sale were £3,709 million received in cash, and the profit was £2,358 million.

The sale of Yell, BT's classified advertising directory businesses in the UK and the USA, was completed on 22 June 2001 for a consideration of £1,960 million, giving a profit of £1,128 million. In May 2001, the UK Office of Fair Trading announced that the price controls over the UK Yellow Pages advertising rates were to be tightened significantly. The price we achieved for the sale of Yell, which was announced on 26 May 2001, reflected the impact of these controls on Yell's prospects.

BT completed the sale of its 18% interest in Airtel, a major Spanish wireless operator, to Vodafone for £1,084 million on 29 June 2001. The profit of £844 million on the sale compares with BT's investment in the company of £223 million, built up during the 1990s.

In November 2001, BT completed the sale of its 33% interest in Maxis Communications of Malaysia for £350 million, which broadly equated with its carrying value. We completed the sale of our interest in Rogers Wireless to AT&T for £267 million on 29 June 2001 and recognised a loss of £23 million.

BT's interest in BiB was diluted in July 2000 when BSKyB gained control and in May 2001 we agreed to exchange our residual interest in BiB for tranches of shares in BSKyB. We received the first tranche of 19 million BSKyB shares with an initial value of £128 million on 28 June 2001. We are required to hold 50% of this tranche until May 2002 and will recognise a profit on these shares as they become marketable. We are also due to receive the second tranche of BSKyB shares with a similar value in November 2002, the gain on which will also be recognised as they become marketable. The profit of £120 million recognised in the 2002 financial year relates to the BSKyB shares which we were permitted to sell on receipt.

In December 2001, BT completed the sale of its wholly owned subsidiary company, Clear Communications Limited, which operates a communications network in New Zealand, for consideration of £119 million. A loss of £126 million has been recognised on this sale of which £45 million relates to goodwill taken directly to reserves before April 1998.

In February 2002, we completed the sale of our 50% interest in e-peopleserve, a major human resource outsourcing activity, to our joint-venture partner, Accenture, for initial consideration of £50 million. BT is entitled to receive additional payments from an earn-out arrangement based on e-peopleserve's revenues from customers other than BT and Accenture over the five years to 2007. These additional earn-out payments will total between £27 million and approximately £167 million. A profit of £61 million on this transaction has been recognised in the 2002 financial year based on the initial consideration and the discounted value of the additional minimum payments, £20 million.

In the 2001 financial year, we sold our 34% interest in sunrise communications of Switzerland to another joint venture partner in November 2000 for £464 million, realising a profit of £454 million. This was the main element in the total profit from disposals of group undertakings and fixed asset investments of £619 million in that year. Other profits during the year were principally derived from the disposal of certain of our aeronautical and maritime interests, the sale of an interest in I.Net by way of a public offering, the reduction of our equity interest in BiB to below 20% and the sale of minor equity investments.

In addition, in the 2002 financial year we recognised an impairment charge of £347 million in relation to the fixed asset investment in AT&T Canada, as noted above, and £157 million in relation to Impsat.

Profit on sale of property fixed assets

In December 2001, as part of a wider property outsourcing arrangement, BT completed the sale and leaseback of the majority of its UK properties to Telereal, a joint venture partnership formed by Land Securities Trillium and The William Pears Group. Around 6,700 properties were

transferred totalling some 5.5 million square metres. The consideration received amounted to £2,380 million. BT has leased the properties back at a total annual rental commencing at £190 million and subject to a 3% annual increase. In addition, BT has transferred the economic risk on a large portion of its leased properties to Telereal in return for an annual rental commencing at approximately £90 million per annum. This is broadly equivalent to the current level of rentals. In February 2002, BT outsourced its property management unit to Telereal.

BT has the option to purchase the reversionary interest from Telereal (i) when BT vacates a property at open market value (ii) at the end of 30 years for the specialised estate (buildings of an operational nature such as telephone exchanges) at open market value or (iii) if BT wishes to terminate all arrangements with Telereal at any time, in which circumstances BT would pay open market values for the property and compensation to Telereal covering funding costs and equity return. BT can also re-acquire the reversion of the general estate (non-operational buildings such as offices and warehousing) at the end of the headlease term of 999 years. BT has the right to renew the lease of the specialised estate for successive periods which, in total, amount to 130 years. After 130 years, the freehold specialised properties revert to BT. The leases include normal commercial restrictions and covenants.

BT's divestment of its property estate will provide a flexible approach to BT's office arrangements and building requirements. BT expects to reduce its property needs over time and the transaction allows BT to vacate properties covering approximately 35% by rental value of the estate, including existing lease ends, over the contract term without penalty.

The profit on the sale of the properties amounted to £1,019 million and was determined after allowing £129 million for BT's actual or potential future obligations under the terms of the legal agreement with Telereal and for the cost of advisors' fees. The obligations include expenditure of £34 million to be incurred on completing nearly finished new properties and remedial work to be undertaken on several properties.

Part of the proceeds of sale have been used in novating fixed interest rate obligations to support Telereal's financing. An exceptional cost of £162 million has been incurred in unwinding this position and is included in the interest charge for the year.

In summary, the property transaction has benefited the results for the 2002 financial year by £857 million as shown below:

Profit on sale and leaseback of properties	£m
Sales proceeds	2,380
Net book value of assets disposed	(1,232)
Estimated cost of BT's future obligations	(129)
Profit on properties sold	1,019
Interest rate swap novation costs	(162)
Net profit on sale and leaseback of properties	857

The rentals payable under the lease will have an adverse impact on other operating costs in future years, initially around £190 million for the 2003 financial year. It is expected that this will be wholly offset by reduced depreciation and interest charges.

In advance of the property transaction being completed with Telereal, BT also completed the sale of one of its major properties in London at a profit of £43 million.

Interest charge

In the 2002 financial year, the total net interest charge, including BT's share of its ventures' charges, at £1,622 million was £308 million higher than in the preceding year, which in turn was £932 million higher than in the 2000 financial year. Of the total charge, £1,540 million arises in the BT group for the 2002 financial year, compared with £1,044 million and £306 million in the 2001 and 2000 financial years, respectively.

The substantially higher charge in the 2002 and 2001 financial years are mainly due to the cost of funding the acquisition of mmO2's third-generation mobile licences, principally in the UK and Germany, and the cost of acquisitions in the 2001 and 2000 financial years. In the 2002 financial year, the group's net interest charge was further increased by the £162 million exceptional cost of novating interest swaps as a consequence of the property sale and leaseback transaction. In the 2001 financial year, there was also a one-off £194 million increase in BT's share of its ventures' interest charges principally through the Japanese investments and Viag Interkom which was partly offset by an exceptional interest receipt of £25 million relating to the rates refund from the UK Government, noted above.

The 2002 financial year did not have the full year benefit of the £5.9 billion proceeds raised by the rights issue and the £8.0 billion proceeds from the disposal of non-core businesses. This will reduce interest charges in the 2003 financial year.

Interest cover for continuing activities in the 2002 financial year represented 1.9 times total operating profit before goodwill amortisation and exceptional items, and compares with interest cover of 2.4 in the 2001 financial year and 10.0 in the 2000 financial year. The decline in cover is due to the increase in the interest charge and decrease in the operating profit before goodwill amortisation and exceptional items. We expect the net interest charge to decrease and interest cover to improve in the 2003 financial year following the significant reduction in net debt during the 2002 financial year.

Profit (loss) and taxation

The group's profit before taxation for the 2002 financial year was £1,461 million, compared with a loss of £1,031 million in the 2001 financial year and a profit of £2,942 million in the 2000 financial year. The profit in the 2002 financial year included the exceptional profits from the sale of investments and businesses totalling £4,389 million. The loss in the 2001 financial year was principally due to the £3,200 million exceptional goodwill impairment charges.

The group's profit before taxation from continuing activities before goodwill amortisation and exceptional items for the 2002 financial year was £1,273 million, compared with £1,763 million in the 2001 financial year and £2,973 million in the 2000 financial year. The significantly lower underlying profits in the 2002 and 2001 financial years were principally due to the higher interest charges and lower operating profits explained above.

The tax charge for the 2002 financial year was £443 million and comprises £528 million on the profit before taxation before the exceptional items on continuing activities, offset by tax relief of £143 million on certain exceptional charges and £58 million tax charge on discontinued activities. The tax charge on the profit from continuing activities before exceptional items and goodwill amortisation is at an effective rate of 41.5%. This is in excess of the standard UK tax rate of 30% due to the impact of loss making subsidiaries outside the UK for which tax relief is not immediately available and associate company taxation.

The tax charge of £712 million for the 2001 financial year represents 34.4% of profit before exceptional items and goodwill amortisation. This compares with a tax charge of 30.9% for the 2000 financial year. The standard UK corporation tax rate was 30% for all three years.

The figures for the 2001 and 2000 financial years have been restated for the new UK accounting standard FRS 19, implemented on 1 April 2001, under which we have made full provision for deferred taxation liabilities.

The minority interests in the results of the 2001 financial year of £127 million were primarily attributable to outside interests in the Japanese investments.

Earnings (loss) and dividends

The basic earnings per share of 12.0 pence per share for the 2002 financial year compares with a loss of 25.7 pence for the 2001 financial year and earnings of 27.6 pence for the 2000 financial year. These results include those of mmO2 and the group's other discontinued activities up to the date of demerger or sale, as well as significant exceptional items and goodwill amortisation. The following table illustrates the impact of these factors on the earnings per share for the past three financial years:

	2002 pence	2001 pence	2000 pence
Earnings per share from continuing activities before goodwill amortisation and exceptional items	8.8	19.3	29.5
Exceptional items and goodwill amortisation from continuing activities	(43.6)	1.4	(0.3)
Earnings (loss) per share from continuing activities	(34.8)	20.7	29.2
Earnings (loss) per share from discontinued activities	46.8	(46.4)	(1.6)
Total earnings (loss) per share	12.0	(25.7)	27.6

Basic earnings per share before goodwill amortisation and exceptional items, from BT's continuing activities of 8.8 pence for the 2002 financial year compares with an equivalent 19.3 pence and 29.5 pence for the 2001 and 2000 financial years, respectively. The results for both the 2002 and 2001 financial years reflect the higher interest charges, losses incurred by newly acquired businesses and the adverse effect which competitive pressures have continued to have on our operating margins in the UK fixed-voice telephony market.

Diluted earnings per share are not materially different.

A final dividend for the 2002 financial year of 2.0 pence per share has been recommended. If approved at the annual general meeting, this dividend will be paid on 9 September 2002 to shareholders on the register on 9 August 2002. This dividend will absorb £173 million. BT's future dividend policy will be progressive, reflecting the growth in earnings per share and an improving balance sheet. It is likely dividend cover during the next three years will be in the range of 2.5 to 2.0 times, reducing within the range as the group's cash position improves.

As part of BT's debt reduction and restructuring plans, the Board decided in May 2001 that there was to be no interim dividend for the 2002 financial year, nor any final dividend in respect of the 2001 financial year. The dividend for the 2001 financial year of 7.8 pence per share therefore solely comprised the interim dividend paid in February 2001 which absorbed £571 million.

Interim and final dividends totalled 19.6 pence per share for the 2000 financial year and absorbed £1,426 million.

Financing

Net cash inflow from operating activities of £5,257 million in the 2002 financial year compares with £5,887 million in the 2001 financial year and £5,849 million in the 2000 financial year. Net cash inflow from continuing operating activities amounted to £5,023 million, £5,410 million and £5,609 million in the 2002, 2001 and 2000 financial years, respectively. Special and deficiency contributions to the

main pension fund, described below, of £600 million in the 2002 financial year, £300 million in the 2001 financial year and £230 million in the 2000 financial year were paid, consequently reducing the net cash inflow by these amounts.

Tax paid in the 2002 financial year totalled £562 million compared with £669 million in the 2001 financial year and £1,311 million paid in the 2000 financial year. The lower tax paid in the 2002 and 2001 financial years was due to the lower profits earned in the 2002 and 2001 financial years.

The net cash outflow of £1,354 million for capital expenditure and financial investment in the 2002 financial year included £4,069 million of capital expenditure on plant and equipment, offset by £2,645 million received on the sale of tangible fixed assets. These proceeds included £2,380 million from the property sale and leaseback transaction completed in December 2001, described above. Net cash outflow of £8,442 million for capital expenditure and financial investment in the 2001 financial year was principally for capital expenditure on plant and equipment of £4,756 million and £4,208 million invested in mmO2's third-generation mobile licences. The net cash outflow of £3,752 million in the 2000 financial year was principally for capital expenditure on plant and equipment.

The net cash inflow from disposals less acquisitions in the 2002 financial year totalled £5,785 million. Cash proceeds from disposals amounted to £6,916 million and principally comprised £3,075 million from the sale of the investment in Japan Telecom and J-Phone, £1,838 million from the sale of the Yell directories business and £1,084 million from the sale of our investment in Airtel. The principal cash outflow for acquisitions was the completion of the purchase of a minority interest in Esat Digifone in April 2001 for £869 million.

In the 2001 financial year, the group made significant acquisitions and the net cash outflow on these totalled £13,754 million in that year. This included £11,438 million invested in Viag Interkom, including acquisition of its licences, £1,233 million in Telfort, £1,176 million in completing the Esat Telecom Group acquisitions, offset by

Summarised cash flow statement	2002 £m	2001 £m	2000 £m
Net cash inflow from operating activities:			
Continuing activities	5,023	5,410	5,609
Discontinued activities	234	477	240
Total net cash inflow from operating activities	5,257	5,887	5,849
Dividends from associates and joint ventures	2	10	5
Net cash outflow for returns on investments and servicing of finance	(1,695)	(727)	(163)
Taxation paid	(562)	(669)	(1,311)
Net cash outflow for capital expenditure and financial investment	(1,354)	(8,442)	(3,752)
Net cash inflow (outflow) for acquisitions and disposals	5,785	(13,754)	(6,405)
Equity dividends paid	-	(1,432)	(1,364)
Cash inflow (outflow) before management of liquid resources and financing	7,433	(19,127)	(7,141)
Management of liquid resources	(1,864)	(480)	1,236
Net cash inflow (outflow) from financing	(5,479)	19,735	5,959
Increase in cash in the year	90	128	54
Decrease (increase) in net debt in the year	13,930	(18,942)	(6,582)

£464 million received principally on the disposal of sunrise communications. The net cash outflow on acquisitions of £6,405 million in the 2000 financial year was principally £3,014 million on the acquisition of the minority interest in BT Cellnet, £1,254 million invested jointly with AT&T in Japan Telecom and £659 million in Canadian interests, jointly owned with AT&T.

There were no equity dividends paid in the 2002 financial year, as explained above. Equity dividends paid in the 2001 financial year totalled £1,432 million, compared with £1,364 million in the 2000 financial year. Subject to shareholder approval, we will resume paying equity dividends in September 2002 with the payment of the final dividend for the 2002 financial year which will amount to £173 million.

The resulting cash inflow for the 2002 financial year, before management of liquid resources and financing, of £7,433 million was mainly applied in repaying short-term borrowings and investing in short-term investments, with total borrowings of £12,006 million being repaid. In the 2001 financial year, the significant cash outflow of £19,127 million was funded by issuing substantial amounts of long-term debt instruments and drawing on medium-term notes programmes. In December 2000, £6,909 million was raised through the issue of four series of US dollar notes totalling \$10 billion, with maturities between three and thirty years. In February 2001, £6,038 million was received through the issue of six series of euro and sterling notes totalling €9.7 billion, with maturities between two and sixteen years. In April 2000, a twenty-five year £250 million index-linked Eurobond was issued.

In the 2000 financial year, there was a net cash outflow of £7,141 million which was partly funded by the issue of new long-term financial instruments, principally two US dollar Eurobonds totalling US\$1.2 billion and a £600 million Eurobond. In that year, we also drew on commercial paper programmes under which approximately £4.9 billion was outstanding at 31 March 2000 and used the group's existing short-term investments.

The cash inflow for the 2002 financial year resulted in net debt reducing to £13,701 million whilst in the 2001 financial year the cash outflow resulted in net debt increasing to £27,942 million at 31 March 2001. In the previous financial year, the cash outflow for the year resulted in net debt increasing to £8,700 million at 31 March 2000.

In the 2002 financial year, the group repaid borrowings totalling £12,006 million and no new long-term debt was raised. This was in part due to the success of the company's rights issue which closed in June 2001. We issued 1,976 million new shares for a total consideration of £5,876 million, net of expenses. As part of the demerger arrangements, £440 million was received from mmO2; additionally mmO2 assumed £60 million of the group's external net debt.

In the 2001 financial year, the group borrowed £14,552 million in long-term loans and repaid £225 million in long-term debt. This was in accordance with our intention, expressed at the end of the 2000 financial year, to

refinance a significant part of our commercial paper borrowings with medium or longer-term debt when market conditions allowed and also to raise further significant finance in the 2001 financial year to meet the financing needs of the UK third-generation mobile licence, won in April 2000, increased capital expenditure and acquisitions of interests in subsidiaries, joint ventures and associates and their additional funding requirements.

In April 2000, BT issued a £250 million 3.5% index-linked Eurobond repayable in 2025. In December 2000, we issued four series of notes comprising US\$2.8 billion 8.625% thirty-year notes, US\$3.0 billion 8.125% ten-year notes, US\$3.1 billion 7.625% five-year notes and US\$1.1 billion three-year floating rate notes. In February 2001, we issued six series of notes comprising £700 million 7.5% sixteen-year notes, €2.25 billion 6.875% ten-year notes, €3.0 billion 6.125% six-year notes, £400 million 7.125% six-year notes, €1.75 billion 5.625% three-year notes and €1.0 billion two-year floating rate notes. Loans repaid during the year totalling £225 million were mainly in respect of the Esat Telecom acquisition.

In the 2000 financial year, the group borrowed £1,473 million in long-term loans and repaid £587 million in long-term debt. In May 1999, BT issued a £600 million 5.75% Eurobond repayable in 2028 and, in October 1999, a US\$1.0 billion 6.75% five-year Eurobond. In August 1999, BT repaid a US\$200 million Eurobond on maturity which was refinanced by a further ten-year US\$200 million Eurobond. On the acquisition of Esat, BT assumed approximately £550 million of debt, based on Esat's 31 December 1999 balance sheet.

In the 2003 financial year, £2,195 million of debt falls due which we anticipate we will fund out of our existing short-term investments. We expect that the short-term investments and cash balance of £4,739 million will fall during the 2003 financial year as debt matures and seasonal cash outflows occur.

We expect to see a continued improvement in the financial position of BT and are seeking to obtain a single A rating from all the major rating agencies.

Treasury policy

The group has a centralised treasury operation which has remained following the progressive devolution of the group's operations. 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 treasury department's policy and its activities are subject to a set of controls commensurate with the magnitude of the borrowings and investments 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.

We have set out further details on this topic and on our capital resources and foreign currency exposure in note 36 to the financial statements in compliance with FRS 13.

Capital resources

During the 2002 financial year the group has reduced its level of borrowings so that its net debt was £13.7 billion at 31 March 2002 compared with £27.9 billion a year earlier. During the 2001 financial year, the group had increased its level of borrowings from £8.7 billion at 31 March 2000. The debt reduction in the 2002 financial year was achieved by our successful rights issue in June 2001, the mmO2 demerger, sales of investments and the Yell business and the property sale and leaseback transaction.

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.

There has been no significant change in the financial or trading position of the group since 31 March 2002.

At 31 March 2002, the group had cash and short-term investments of £4,739 million. At that date, £2,195 million of debt falls due for repayment in the 2003 financial year. In addition, the group had unused committed short-term bank facilities, amounting to approximately £2,100 million at 31 March 2002, in support of a commercial paper programme or other borrowings. The group also has £461 million of uncommitted short-term bank facilities.

At 31 March 2001, the group had cash and short-term investments of £2,969 million. At that date, £11,629 million of short-term debt was outstanding, comprising principally £3,494 million of borrowings under BT's commercial paper programmes and £7,094 million under its medium-term note programme. In addition, the group had unused committed short-term bank facilities, amounting to approximately £16,750 million at 31 March 2001, in support of a commercial paper programme or other borrowings.

Foreign currency and interest rate 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 £14.3 billion at 31 March 2002, are used to finance its operations. Of these borrowings, approximately £13.6 billion was swapped into sterling. Cross currency swaps and forward foreign exchange contracts have been entered into to reduce the foreign currency exposure on the group's operations and the group's net assets. The group also enters into forward foreign exchange contracts to hedge investment, interest expense and purchase and sale commitments. The commitments hedged are principally US dollars, the euro and the yen. As a result of these policies, the group's exposure to foreign currency arises mainly on the residual currency exposure on its non-UK investments in its subsidiaries and ventures and on any imbalances between the value of outgoing and incoming international calls. 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 in the three years under review.

The majority of the group's long-term borrowings has been, and is, subject to fixed interest rates. The group has entered into interest rate swap agreements with commercial banks and other institutions to vary the amounts and period for which interest rates are fixed. At 31 March 2002, the group had outstanding interest rate swap agreements with notional principal amounts totalling £7,870 million compared to £9,574 million at 31 March 2001.

The long-term debt instruments which BT issued in December 2000 and February 2001 both contained covenants that if the BT group credit rating were downgraded below A3 in the case of Moody's or below A minus in the case of Standard & Poor's (S&P), additional interest would accrue from the next interest coupon period at the rate of 0.25 percentage points for each ratings category adjustment by each ratings agency. In May 2001, Moody's downgraded BT's credit rating to Baa1, which increases BT's annual interest charge by approximately £32 million. BT's credit rating from S&P is A minus. Based upon the total amount of debt of £12.8 billion outstanding on these instruments at 31 March 2002, BT's annual interest charge would increase by approximately £65 million if BT's credit rating was to fall by one credit rating category by both agencies below a long-term debt rating of Baa1/A minus.

Based upon the composition of net debt at 31 March 2002, a one percentage point increase in interest rates would increase the group's annual net interest expense by less than £20 million. Based upon the composition of net debt at 31 March 2001, a one percentage point increase in interest rates would have increased the group's annual net interest expense by less than £90 million.

The group's exposure to changes in currency rates decreased following the demerger of the mmO2 business including its activities in Europe. A 10% strengthening in sterling against major currencies would cause the group's net assets at 31 March 2002 to fall by less than £150 million, with insignificant effect on the group's profit. This compares with a fall of less than £1,200 million in net assets based on the group's net assets at 31 March 2001 using the same variation in currency rates. Foreign exchange contracts are entered into as a hedge of sales and purchases, accordingly a change in the fair value of the hedge is offset by a corresponding change in the value of the underlying sale or purchase.

Capital expenditure

Capital expenditure on plant, equipment and property totalled £3,908 million in the 2002 financial year, compared with £4,986 million in the 2001 financial year and £3,680 million in the 2000 financial year. Of the total capital expenditure, £3,100 million, £3,857 million and £3,160 million were in relation to the group's continuing activities in the 2002, 2001 and 2000 financial years, respectively. Work continues on enhancing the intelligence

of the network to enable customers to benefit from advanced services and improving the network's capacity to carry high-speed data. We had installed ADSL equipment in 1,010 UK exchanges by 31 March 2002 as the continuation of our plan to roll out this equipment to all our major local exchanges. We are progressively changing the fixed network from one based on switched technologies to a modern network based on the internet protocol (IP). In the 2002 financial year 13 trunk exchanges in the core network were cut-over to Next Generation Switches (NGSs) which have double the capacity of the earlier exchanges. This brought the total of NGSs to 70 by 31 March 2002. Plans are in place for the upgrade and expansion of 23 of the switches to include Voice over Asynchronous Transfer Mode (VoATM) switching by March 2003, which potentially doubles the port capacity of each switch. Investment in the access network continued to be driven by demand for both new copper and fibre lines and by quality and resilience improvement programmes.

Capital expenditure in relation to the group's discontinued activities amounted to £808 million, £1,129 million and £520 million in the 2002, 2001 and 2000 financial years, respectively. Prior to the demerger, mmO2 continued improving the quality and capacity of its digital GSM network. In April 2000, we purchased one of the five 3G licences in the UK Government's auction for £4.03 billion, which we paid in May 2000. A third generation mobile licence in the Netherlands was awarded to Telfort in July 2000 for £267 million.

Of the capital expenditure, £634 million was in Europe, outside UK, in the 2002 financial year and £632 million was spent there in the 2001 financial year, following our acquisition of Esat, Telfort and Viag Interkom, in building out their networks. In the 2000 financial year, £233 million was incurred in North America mainly by Concert Communications before the establishment of the Concert global venture in January 2000.

The group expects capital expenditure in the 2003 financial year to be below £3 billion. Contracts placed for ongoing capital expenditure totalled £740 million at 31 March 2002. We plan to continue to spend on our IP backbone network, in providing web hosting facilities and continuing the expansion of our networks to meet the projected broadband demand. We are focusing capital expenditure on projects with higher and more immediate financial returns. BT expects that future capital expenditure will be provided from net cash inflows from operating activities, and, if required, by external financing.

Acquisitions

The total amount invested in the 2002 financial year, including further funding of existing ventures, was £1,131 million. We made only one significant acquisition, being the purchase in April 2001 of the 49.5% interest in Esat Digifone that we did not already own, from Telenor, for £869 million under an agreement made in early 2000. During December 2001, Mediaset exercised a put option in respect of its 9% interest in Blu, an Italian mobile phone

operator. BT has reviewed the carrying value of its investment and provision has been made for the associated impairment and exit costs.

During the 2001 financial year, BT completed a number of acquisitions of businesses, mainly located outside the UK. The total amount invested, including further funding of existing ventures, was £14,501 million.

In April 2000, we took an equity interest, jointly with Japan Telecom, in a number of regional Japanese mobile phone companies (J-Phone Communications). Instead of investing directly in J-Phone Communications, we guaranteed bank loans to that group totalling £782 million at 31 March 2001. As noted above, we have now sold our interests to Vodafone for £3.7 billion. In June 2000, we acquired for £1,207 million our partner's 50% interest in Telfort, the communications joint venture which we established in the Netherlands in 1997. The wireless business of Telfort was demerged with mmO2 in November 2001. In the 2002 financial year the remaining goodwill was written off.

In the final quarter of the 2001 financial year, we acquired the 55% interest in Viag Interkom that we did not already own under agreements made in August 2000. In January 2001, we acquired a 10% interest in Viag Interkom including its share of the German third generation licence from Telenor for £1,611 million, and in February 2001, we acquired the remaining 45% interest from E.ON for £7,148 million, including its share of the cost of the licence. Goodwill of £4,992 million arose on the transactions. In the light of falling equity valuations for wireless companies in the 2001 financial year, we carried out impairment reviews of the carrying values of Viag Interkom and other major wireless interests at that time. As discussed above, we recognised a £3,000 million goodwill impairment in Viag Interkom of which £200 million related to the fixed network business remaining in the BT Group after the mmO2 demerger. In the 2002 financial year the remaining goodwill was written off.

During the 2000 financial year, BT also completed a number of acquisitions of businesses or interests in ventures. The total amount invested, including deferred considerations and further funding of existing ventures, was £8,755 million. The investment in the Concert global venture, in the form of assets contributed, was additional to this.

In November 1999, we completed the acquisition of the 40% minority interest in BT Cellnet held by Securicor. The total cost of this acquisition was £3,173 million, including legal fees and other expenses. BT Cellnet was demerged as a significant part of mmO2 in November 2001.

BT acquired jointly with AT&T a 30% interest in Japan Telecom for £1,254 million in August 1999, with BT having an economic interest of 20%. Concurrent with this transaction, BT sold its Japanese subsidiary to Japan Telecom.

In Canada, BT acquired an effective 9% economic interest in AT&T Canada. In conjunction with AT&T, we jointly purchased 33% of Rogers Wireless (formerly Rogers

Cantel Mobile Communications), a leading mobile operator, leaving BT with an effective interest of approximately 17%. The consideration paid by BT in August 1999 for these two investments totalled £659 million. We have now sold our interests in Rogers Wireless and have exited from AT&T Canada.

In January 2000, BT and AT&T announced the financial completion of Concert, the global communications joint venture. This venture was formed by BT transferring the majority of its cross-border international network assets, its international traffic, its business with selected multinational customers, together with Concert Communications, and AT&T transferring similar assets and businesses. The provisional unrealised profit on transferring these assets of £159 million was recognised in BT's statement of total recognised gains and losses in the 2000 financial year. During the 2001 financial year, certain true-up calculations were made causing a downward adjustment of £49 million to the unrealised profit which has been recognised in this year's statement of total recognised gains and losses. As noted above, the Concert joint venture has now been unwound.

In August 1999, we completed the acquisition of the Yellow Book USA classified directory advertising business based in New York for a total consideration of £415 million. The company was sold in June 2001 as part of the Yell transaction. Also in August 1999, we acquired Control Data Systems (renamed Syntegra (USA)), a US-based e-commerce and systems integration company, for £213 million. In May 1999, we acquired a 20% interest in SmarTone of Hong Kong, a leading provider of digital mobile communications services, for £241 million.

Under an agreed offer made in January 2000 and separate transactions with two of its major shareholders, we acquired control of Esat Telecom Group (Esat) at the end of March 2000, following regulatory clearance. We paid the majority of the consideration of £1,558 million in April 2000 after the 2000 financial year end. This Irish communications group held a 49.5% interest in Esat Digifone, Ireland's second largest mobile phone operator. We acquired a further 1% in this company in January 2000, so it also became part of the BT group at the end of March 2000. As noted above, Telenor was the other shareholder in Esat Digifone, with a 49.5% interest which we acquired in April 2001. Esat Digifone was demerged with mmO2 in November 2001, and the remaining goodwill was written off in the 2002 financial year.

Balance sheet

The group balance sheet has undergone a major transformation since 31 March 2001. To help understand the changes, we have presented an unaudited pro forma balance sheet in our financial statements as a comparative to illustrate the impact of the demerger of mmO2 and the sale of other discontinued businesses as if they had occurred on 31 March 2001.

The net assets attributable to mmO2 at the date of demerger totalled £19,490 million, including £16,193 million

of goodwill, mobile licences and other intangible assets, and £4,216 million of tangible fixed assets. These net assets were distributed by way of a demerger distribution which is the main cause of the reduction in group shareholders' funds from £12,054 million at 31 March 2001 to a deficit of £358 million at 31 March 2002. The reduction has been mitigated by the impact of the June 2001 rights issue which increased shareholders' funds by £5,876 million.

BT Group plc, the parent company, has reserves of £9,537 million, although the consolidated reserves are showing a deficiency of £794 million.

BT's fixed assets totalled £17,551 million of which £16,078 million were tangible assets, principally forming the UK fixed network. Provisions for liabilities and charges include a deferred tax provision of £2,140 million for our full exposure to deferred tax as required under FRS 19. Although we have chosen not to discount our liability, we only expect to settle a small part of this amount in the foreseeable future.

Return on capital employed

The group made a return from continuing activities before goodwill amortisation and exceptional items of 15.7% on the average capital employed in its business excluding mmO2 and goodwill, on a historical cost basis, in the 2002 financial year. In the 2001 and 2000 financial years, the group made a return on all activities of 14.9% and 18.2%, respectively.

Pensions

The most recently completed actuarial valuation of the BT Pension Scheme (BTPS), BT's main pension fund, performed for the trustees of the scheme, was carried out as at 31 December 1999. This valuation revealed the fund to be in deficit to an amount of approximately £982 million, after taking credit for a special contribution of £230 million paid by BT in March 2000. Assets of the fund of £29,692 million at that date covered 97% of the fund's liabilities. This actuarial valuation took into account the anticipated effect of the High Court judgement noted below.

The group's annual pension charges for the 2002 and 2001 financial years of £361 million and £326 million, respectively have been based on this December 1999 valuation, but using a slightly higher investment return assumption than was used for the trustees' funding valuation summarised above. The group's pension charge for the 2000 financial year of £167 million was based on the December 1996 valuation.

The increase in the pension charge in the 2002 and 2001 financial years was due, in part, to the smaller amortisation of the combined pension fund position and pension provision held in the BT group balance sheet. The amortisation credit netted in pension costs amounted to £nil in the 2002 financial year compared with £35 million in the 2001 financial year and £163 million in the 2000 financial year.

Additionally, under UK accounting standards, if the costs of providing incremental pension benefits for early leavers are less than the total accounting surplus based on the latest actuarial valuation of the scheme and the amount of the provision for pension liabilities on the balance sheet, the costs are not charged to the profit and loss account. In the 2000 and 2001 financial years the cost of the incremental benefits has not been charged against the profit in the period in which people agree to leave. In the 2002 financial year the total cost of the incremental pension benefits exceeded the total accounting surplus and accordingly the excess was charged to the profit and loss account. The share of operating profit of associates includes £6 million and group operating profit includes £21 million of the charge.

The group's ordinary contribution into the fund was raised to 11.6% of employees' pensionable pay for the 2002 and 2001 financial years compared with 9.5% of pay during the 2000 financial year. In addition, the company paid special and deficiency contributions into the fund of £600 million in the 2002 financial year, £300 million in the 2001 financial year and £230 million in the 2000 financial year in part because of redundancies. The company is committed to pay deficiency funding contributions of £200 million each year until such time as the funding deficit is made good. The company may also be required by the trustees of the fund to pay special contributions to cover any costs on the pension fund arising from early leavers. The deficiency and special contributions paid in the 2002 financial year included £400 million in respect of early leavers in the 2000 calendar year.

The number of retired members and other current beneficiaries in the pension fund has been increasing in recent years and, at 31 December 2001, was approximately 62% higher than the number of active members. Consequently, BT's future pension costs and contributions will depend to a large extent on the investment returns of the pension fund and could fluctuate in the medium term.

Following a High Court judgement made in October 1999, the BTPS is required to pay additional benefits to certain former employees of the group who left under voluntary redundancy terms. These were former employees, in managerial grades, who had joined the group's business prior to 1 December 1971. The value of these additional benefits is estimated to be £200 million.

We have now changed the arrangements for people leaving BT in advance of the normal retirement age. Under our NewStart programme launched during the fourth quarter of the 2001 financial year, BT employees will be expected to leave with a leaving payment in place of a redundancy payment, and incremental pension benefits are being scaled down. This should reduce early leaver costs, which have been significant in recent years.

The next actuarial valuation of the BTPS will be undertaken at 31 December 2002.

The BTPS was closed to new entrants on 31 March 2001 and we launched a new defined contribution pension scheme for people joining BT after that date which is to

provide benefits based on the employees' and the employing company's contributions. This change is in line with the practice increasingly adopted by major UK groups and is designed to be more flexible for employees and enable the group to determine its pension costs more precisely than is the case for defined benefit schemes. The financial impact of this change was not significant in the 2002 financial year and is not expected to be significant in the next several years but it should reduce pension costs in the longer term.

Regulation and prices

BT has been operating under the existing retail price control from 1 August 1997, under which a cap of RPI minus 4.5 applies to the services used by the lowest 80% of BT's residential customers by bill size. This retail price control is estimated to have covered services representing about 13% of the group's turnover from continuing activities for the 2002 financial year. In the nine month period to May 2002 BT has reduced its prices by 2.73%, which compares to the required reduction of 2.44% for the price control year to 31 July 2002. The equivalent reduction in the previous control year was 1.20% against the required reduction of 1.09%.

Most of BT's interconnect (network) charges to other UK operators are based on long-run incremental costs. Until 30 September 2001, there were annual reductions in these charges based on a RPI minus 8 price cap. Since that date, the broad structure of the interconnect (network) services has been retained but the "X" within the RPI minus X price-cap formula now varies between 7.5 and 13, this new price control runs until 2005.

The Competition Commission (CC) required BT to reduce charges from a BT line to mobile phones by around 25% in the 1999 financial year and an effective annual RPI minus 7 reduction for the 2000 and 2001 financial years.

The regulatory environment in the UK has had, and is expected to continue to have, a significant adverse impact on the group's turnover and operating profit. As the group has extended its activities to other countries, BT is required to consider the regulatory regimes in those countries.

Competition and the UK economy

BT has a significant market share in its main UK markets for fixed network calls and provision of exchange lines.

Competition has eroded BT's market share significantly in the past in key market sectors, in particular areas of the UK and for certain products and services. This trend has now slowed and we estimate that BT had 73% of the market for residential voice calls in the 2002 financial year, compared with 74% and 78% in the 2001 and 2000 financial years, respectively. Additionally, we estimate that BT had 48% of the market for business voice calls in the 2002 financial year, compared with 51% and 57% in the 2001 and 2000 financial years, respectively. BT supplied 83% of the exchange lines in the UK at 31 March 2002, compared with 84% and 84% at 31 March 2001 and 2000, respectively.

The growth in cable operators' networks in the UK had an adverse effect on BT's share of the residential market until the 2001 financial year. BT experienced a small net annual

reduction in residential exchange line connections as a result of increasing competition from these cable operators in certain geographic areas. As the cable operators are currently concentrating on increasing penetration in current markets rather than expanding their geographic coverage this is not expected to continue in the short-term.

The group has seen some diversion of demand from its fixed network as a result of the growth in mobile voice calls and other licensed operators' activities. This diversion may intensify now that BT's fixed line customers are able to pre-select their carrier.

Additionally, BT's Licence was amended in April 2000 to require BT to provide other operators with use of the lines connecting BT's local exchanges to its customers and allow operators to install equipment in BT's exchanges (local loop unbundling). As a result of an EU Regulation this amendment took effect from 30 December 2000.

For its operations as a whole, 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 1.0% in the 2002 financial year, compared with 2.9% and 3.0% in the 2001 and 2000 financial years, respectively.

Environment

When removing old analogue exchange equipment from buildings, BT recycles the metal content and takes special care to properly dispose of any hazardous materials. Although BT receives proceeds from the sale of recovered materials, this is more than offset by the cost of dealing with hazardous materials, contracting and planning their removal and preparing the released site for further development. BT believes that the total cost of dealing with these hazardous materials will not be significant.

Geographical information

In the 2002 financial year, approximately 89% of the group's turnover, including discontinued activities, was generated by operations in the UK, compared with 91% in the 2001 and 95% in the 2000 financial years. Of its continuing activities, approximately 92% of the group's turnover was generated by operations in the UK in the 2002 financial year, compared with 95% in the 2001, and 91% in the 2000, financial years. BT's operating profits have been derived from its UK operations with losses being incurred outside the UK in each of the last three financial years.

Regulatory financial information

BT is required under its main licence to publish disaggregated financial information for various activities of the group, which have been used as the basis of charges paid by other telecommunication operators in the UK for the use of BT's network. The activities presented separately in the regulatory financial statements do not necessarily correspond with any businesses separately managed, funded or operated within the group. The results set out in

these statements for the 2001 and 2000 financial years showed that the group's operating profit is derived predominantly from fixed-network calls.

Critical accounting policies

The group's principal accounting policies are set out on pages 72 to 74 of the consolidated financial statements and conform with UK Generally Accepted Accounting Principles (UK GAAP).

We, in common with virtually all other companies, need to use estimates in the preparation of our financial statements. The most sensitive estimates affecting our financial statements are in the areas of assessing the level of interconnect income with and payments to other telecommunications operators, providing for doubtful debts, establishing fixed asset lives for depreciation purposes, making appropriate long-term assumptions in calculating pension liabilities and costs, making appropriate medium-term assumptions on asset impairment reviews and calculating current tax liabilities on our profits.

We are required to interconnect our networks with other telecommunications operators. In certain instances we rely on other operators to measure the traffic flows interconnecting with our networks. We use estimates in these cases to determine the amount of income receivable from or payments we need to make to these other operators. The prices at which these services are charged are often regulated and are subject to retrospective adjustment. We use estimates in assessing the likely effect of these adjustments.

We provide services to over 21 million individuals and businesses, mainly on credit terms. We know that certain debts due to us will not be paid through the default of a small number of our customers. We use estimates, based on our historical experience, in determining the level of debts that we believe will not be collected. These estimates include such factors as the current state of the UK economy and particular industry issues.

The plant and equipment used in our networks is long-lived with cables and switching equipment operating for over 10 years and underground ducts being used for decades. The annual depreciation charge is sensitive to the estimated service lives we allocate to each type of asset. We regularly review these asset lives and change them when necessary to reflect current thinking on their remaining lives in light of technological change, prospective economic utilisation and physical condition of the assets concerned.

We have a commitment, mainly through the BT Pension Scheme, to pay pension benefits to approximately 376,000 people over the next several decades. The cost of these benefits and the present value of our pension liabilities depend on such factors as the life expectancy of the members, the salary progression of our current employees, the return that the pension fund assets will generate in the time before they are used to fund the pension payments and the discount rate at which the future pension payments are discounted. We use estimates for all these factors in

determining the pension costs and liabilities incorporated in our financial statements.

In the 2002 and 2001 financial years, we have made charges for the impairment of the carrying value of goodwill, investments and tangible fixed assets in our balance sheet. The amount of the charges are in most cases based on the discounted present value of the future cash flows that we expect to be derived from these assets. We use estimates in determining these future cash flows and the discount rate.

The actual tax we pay on our profits is determined according to complex tax laws and regulations. Where the effect of these laws and regulations is unclear, we use estimates in determining the liability for the tax to be paid on our past profits which we recognise in our financial statements.

New UK accounting standards

BT Group has implemented the requirements of the new accounting standard FRS 19 "Deferred tax" in the 2002 financial year. The standard requires full provision to be made for deferred tax assets and liabilities arising from timing differences between recognition in the financial statements and in the tax computation. The cumulative impact of FRS 19 in relation to prior years has been recognised in the financial statements as a prior year adjustment and comparative figures for 2001 and 2000 have been restated. For further details, see note 27 to the financial statements.

Under a new UK accounting standard, FRS 17 "Retirement benefits", the method of accounting for defined benefit pensions will be substantially changed. BT will be required to fully adopt this new standard in our 2004 financial year. This standard will have the effect of increasing the pension costs to be included in operating costs, thus reducing operating profit, but this will be offset by financing costs being reduced. Pension fund actuarial gains and losses, including investment returns varying from the assumed returns, will be recorded in full in the statement of total recognised gains and losses annually. Pension fund deficits, calculated in accordance with prescribed rules in the standard, will be shown on the balance sheet as will any surpluses to the extent we expect to obtain value from them in the foreseeable future. In accordance with the transitional rules of the standard the pension fund deficit calculated under FRS 17 is disclosed in note 31. It should be noted that the deficit is largely dependent on the strength of equity markets at the balance sheet date and is expected to be volatile.

Economic and Monetary Union (EMU)

On 1 January 1999, a new currency, the euro, was introduced into the European Union as a part of EMU. Twelve member states have joined EMU and have adopted the euro as their national currency. On 1 January 2002, euro notes and coins were introduced and, following a period of dual circulation, the former national currencies of

all participating member states have now been fully withdrawn from being legal tender.

Most of the group's business in Europe is conducted in the UK, which is not one of the 12 participating member states. Government policy on UK membership of the single currency was set out by the Chancellor of the Exchequer in a statement to the House of Commons in October 1997, as restated by the Prime Minister in February 1999 on the launch of the first Outline National Changeover Plan. The determining factor underpinning any Government decision on membership of the single currency is whether the economic case for the UK joining is clear and unambiguous. Because of the magnitude of the decision, the UK Government believes that, whenever the decision to enter is taken, it should be put to a referendum of the British people. The UK Government has said that it will produce an assessment of five relevant economic tests in this parliament and that both the UK Government and business should make active preparations to give the UK the genuine option to decide to join.

BT has established a steering group, with representatives from across each of the lines of business and supporting group functions, to review the impact of the introduction of EMU. A project team acts as a co-ordination point to ensure consistency of approach across the group and that plans are in place to meet agreed business strategy on EMU.

The group carries on business in certain of the participating member states and has adapted the operations in those countries to the introduction of the euro.

BT is considering the impact of EMU on the UK business and the associated costs.

US GAAP

The group's net income (loss) and earnings (loss) per share for the three financial years ended 31 March 2002 and shareholders' equity at 31 March 2002 and 2001 under US Generally Accepted Accounting Principles (US GAAP) are shown further in the United States Generally Accepted Accounting Principles Section (see Consolidated financial statements). Differences between UK GAAP and US GAAP include results of the differing accounting treatment of leasing transactions, pension costs, redundancy costs, intangible assets, goodwill, deferred taxation, capitalisation of interest, financial instruments, contributing assets to joint ventures, stock compensation, and dividends. Cash flow information under the US GAAP presentation is also shown further in this document.

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 "Business Combinations" which supersedes APB Opinion 16 "Business Combinations". For business combinations initiated after 30 June 2001 SFAS No. 141 requires the purchase method of accounting to be used and disallows the pooling of interests method. SFAS No. 141 also sets out specific criteria for the recognition of intangible assets separately from goodwill and requires unallocated negative goodwill to be written off immediately as an extraordinary gain. The adoption

of SFAS No. 141 will not have a material impact on BT's results of operations, financial position or cash flows.

SFAS No. 142 "Goodwill and Other Intangible Assets" was also issued in July 2001. SFAS No. 142 is applicable to financial years commencing after 15 December 2001. SFAS No. 142 supersedes APB Opinion 17 "Intangible Assets" and requires the discontinuance of the amortisation of goodwill and intangible assets with indefinite lives. These assets will be subject to an impairment review at least annually.

At 1 April 2002 BT has purchased goodwill of £237 million which has been reviewed in accordance with SFAS No. 142 and no impairment charge is required on adoption of SFAS No. 142. This is being amortised over its remaining useful life of 17 years in the UK GAAP financial statements.

In July 2001, the FASB also issued SFAS No. 143 "Accounting for Asset Retirement Obligations" which is applicable to financial years commencing after 15 June 2002. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognised in the period in which it is incurred if it is possible to make a reasonable estimate of the fair value. The associated asset retirement costs are required to be capitalised as part of the carrying value of the long lived asset. The adoption of SFAS No. 143 is not expected to have a material impact on the consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long Lived Assets" which is applicable to financial years beginning after 15 December 2001. SFAS No. 144 supersedes SFAS No. 121 "Accounting for Long Lived Assets and for Long Lived Assets to be Disposed Of". The adoption of SFAS No. 144 is not expected to have a material impact on the consolidated financial statements.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections". The Statement updates, clarifies and simplifies existing accounting pronouncements. BT is currently evaluating the impact of this statement on its consolidated financial statements.