NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1 Basis of preparation and accounting policies

These condensed consolidated financial statements ('the financial statements') comprise the financial results of BT Group plc for the quarters and half years to 30 September 2014 and 2013 together with the audited balance sheet at 31 March 2014. The financial statements for the half year to 30 September 2014 have been reviewed by the auditors and their review opinion is on page 26. The financial statements have been prepared in accordance with the Disclosure and Transparency Rules (DTR) of the Financial Conduct Authority and with IAS 34 *Interim Financial Reporting* as adopted by the European Union. The financial statements should be read in conjunction with the annual financial statements for the year to 31 March 2014.

After making enquiries, the directors have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the half year financial statements.

Except as described below and other than income taxes which are accrued using the tax rate that is expected to be applicable for the full financial year, the financial statements have been prepared in accordance with the accounting policies as set out in the financial statements for the year to 31 March 2014 and have been prepared under the historical cost convention as modified by the revaluation of financial assets and liabilities (including derivative financial instruments) at fair value. These financial statements do not constitute statutory accounts within the meaning of Section 434 of the Companies Act 2006. Statutory accounts for the year to 31 March 2014 were approved by the Board of Directors on 7 May 2014, published on 22 May 2014, and delivered to the Registrar of Companies. The report of the auditors on those accounts was unqualified and did not contain any statement under Section 498 of the Companies Act 2006.

Restatement of certain line of business results

From 1 April 2014 BT Conferencing and BT Security have moved into BT Global Services from BT Business and our central group functions respectively. This will help us simplify the way we provide integrated collaboration solutions to our global customers, better compete in the market and take full advantage of global opportunities. Comparative results for BT Global Services, BT Business and Other and intra-group items have been restated to be presented on a consistent basis.

The impact on line of business results for the six months ending 30 September 2013 was to increase revenue, EBITDA and operating cash flow in BT Global Services by £105m, £49m and £35m respectively and to reduce revenue, EBITDA and operating cash flow in BT Business by £150m, £47m and £39m respectively. Central group functions revenue reduced by £6m, EBITDA reduced by £2m and operating cash flow increased by £4m. Intra-group eliminations on revenue decreased by £51m.

These organisational changes do not impact the results of BT Consumer, BT Wholesale or Openreach and there is no impact on the total group results. More details are set out in our related press release published on 16 June 2014.

We have also revised balance sheet comparatives to present them on a consistent basis with the audited balance sheet at 31 March 2014. Accrued income at 30 September 2013 increased by £38m, with a corresponding increase of £38m in deferred income.

2 Operating results – by line of business[1]

	External revenue £m	Internal revenue £m	Group revenue £m	EBITDA £m	Operating profit (loss) £m
Second quarter to 30 September 2014					
BT Global Services	**1,643**	**6**	**1,649**	**226**	**102**
BT Business	**686**	**103**	**789**	**258**	**213**
BT Consumer	**1,041**	**15**	**1,056**	**225**	**171**
BT Wholesale	**529**	**-**	**529**	**125**	**70**
Openreach	**481**	**764**	**1,245**	**627**	**292**
Other and intra-group items[2]	**3**	**(888)**	**(885)**	**(11)**	**(16)**
Total	**4,383**	**-**	**4,383**	**1,450**	**832**
Second quarter to 30 September 2013					
BT Global Services[3]	1,736	7	1,743	222	70
BT Business[3]	694	105	799	247	197
BT Consumer	977	10	987	158	105
BT Wholesale	624	-	624	159	97
Openreach	455	816	1,271	642	287
Other and intra-group items[2,3]	5	(938)	(933)	6	1
Total	4,491	-	4,491	1,434	757
Half year to 30 September 2014					
BT Global Services	**3,282**	**14**	**3,296**	**439**	**175**
BT Business	**1,360**	**191**	**1,551**	**498**	**410**
BT Consumer	**2,073**	**29**	**2,102**	**463**	**354**
BT Wholesale	**1,054**	**-**	**1,054**	**251**	**137**
Openreach	**957**	**1,533**	**2,490**	**1,251**	**567**
Other and intra-group items[2]	**11**	**(1,767)**	**(1,756)**	**(17)**	**(28)**
Total	**8,737**	**-**	**8,737**	**2,885**	**1,615**
Half year to 30 September 2013					
BT Global Services[3]	3,480	15	3,495	432	127
BT Business[3]	1,378	206	1,584	483	380
BT Consumer	1,915	22	1,937	389	281
BT Wholesale	1,262	-	1,262	316	190
Openreach	894	1,622	2,516	1,247	523
Other and intra-group items[2,3]	11	(1,865)	(1,854)	7	(1)
Total	8,940	-	8,940	2,874	1,500

[1] Before specific items
[2] Elimination of intra-group revenue, which is included in the total revenue of the originating business
[3] Restated, see Note 1 to the condensed consolidated financial statements

3 Operating costs

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	£m	£m	**£m**	£m
Direct labour costs	**1,154**	1,173	**2,331**	2,354
Indirect labour costs	**190**	216	**390**	426
Leaver costs	**1**	4	**3**	10
Total labour costs	**1,345**	1,393	**2,724**	2,790
Capitalised labour	**(260)**	(245)	**(521)**	(483)
Net labour costs	**1,085**	1,148	**2,203**	2,307
Payments to telecommunications operators	**552**	639	**1,082**	1,285
Property and energy costs	**241**	251	**485**	497
Network operating and IT costs	**153**	149	**312**	313
Programme rights charges	**83**	50	**161**	50
Other costs	**819**	820	**1,609**	1,614
Operating costs before depreciation and specific items	**2,933**	3,057	**5,852**	6,066
Depreciation and amortisation	**618**	677	**1,270**	1,374
Total operating costs before specific items	**3,551**	3,734	**7,122**	7,440
Specific items (Note 4)	**112**	52	**156**	136
Total operating costs	**3,663**	3,786	**7,278**	7,576

4 Specific items

The group separately identifies and discloses those items that in management's judgement need to be disclosed by virtue of their size, nature or incidence (termed 'specific items'). This is consistent with the way that financial performance is measured by management and assists in providing a meaningful analysis of the trading results of the group. Specific items may not be comparable to similarly titled measures used by other companies.

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	£m	£m	**£m**	£m
Specific revenue				
Regulation	**(58)**	-	**(58)**	-
Specific operating costs				
Profit on disposal of subsidiary	**(1)**	-	**(1)**	-
Restructuring charges	**60**	52	**104**	136
Provision for regulatory risks	**53**	-	**53**	-
Specific operating costs	**112**	52	**156**	136
EBITDA impact (Note 7)	**54**	52	**98**	136
Net interest expense on pensions	**73**	58	**146**	117
(Profit) loss on disposal of interest in associate	**-**	-	**(25)**	3
Net specific items charge before tax	**127**	110	**219**	256
Tax credit on specific items before tax	**(20)**	(19)	**(42)**	(51)
Tax credit on re-measurement of deferred tax	**-**	(231)	**-**	(231)
Net specific items charge (credit) after tax	**107**	(140)	**177**	(26)

5 Free cash flow

Free cash flow is not a measure defined under IFRS but is a key indicator used by management to assess operational performance.

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	£m	£m	**£m**	£m
Cash generated from operations	**1,202**	1,334	**2,114**	1,993
Tax paid	**(117)**	(72)	**(231)**	(83)
Net cash inflow from operating activities	**1,085**	1,262	**1,883**	1,910
Included in cash flows from investing activities				
Net purchase of property, plant, equipment and software	**(521)**	(634)	**(1,051)**	(1,234)
Interest received	**2**	2	**4**	3
Net purchase of non-current asset investments	**-**	-	**(2)**	-
Included in cash flows from financing activities				
Interest paid	**(89)**	(73)	**(296)**	(296)
Reported free cash flow	**477**	557	**538**	383
Net cash outflow from specific items	**75**	72	**155**	206
Cash tax benefit of pension deficit payments	**(19)**	(19)	**(38)**	(39)
Normalised free cash flow	**533**	610	**655**	550

6 Net debt

Net debt is not a measure defined under IFRS but is a key indicator used by management to assess operational performance.

	30 September	30 September	31 March
	2014	2013	2014
	£m	£m	£m
Loans and other borrowings[1]	**9,241**	9,701	9,814
Cash and cash equivalents	**(648)**	(322)	(695)
Current investments	**(1,152)**	(916)	(1,774)
	7,441	8,463	7,345
Adjustments:			
To re-translate currency denominated balances at swapped rates where hedged	**(104)**	(125)	(24)
To remove fair value adjustments and accrued interest applied to reflect the effective interest method	**(274)**	(264)	(293)
Net debt	**7,063**	8,074	7,028

[1] Includes overdrafts of £17m at 30 September 2014 (30 September 2013: £7m; 31 March 2014: £11m)

7 Reconciliation of earnings before interest, taxation, depreciation and amortisation

Earnings before interest, taxation, depreciation and amortisation (EBITDA) is not a measure defined under IFRS, but is a key indicator used by management to assess operational performance. A reconciliation of reported profit before tax to adjusted EBITDA is provided below.

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	£m	£m	**£m**	£m
Reported profit before tax	**563**	499	**1,109**	948
Share of post-tax (profits) losses of associates and joint ventures	**(1)**	-	**(1)**	2
(Profit) loss on disposal of interest in associate	**-**	-	**(25)**	3
Net finance expense	**216**	206	**434**	411
Operating profit	**778**	705	**1,517**	1,364
Depreciation and amortisation	**618**	677	**1,270**	1,374
Reported EBITDA	**1,396**	1,382	**2,787**	2,738
Specific items (Note 4)	**54**	52	**98**	136
Adjusted EBITDA	**1,450**	1,434	**2,885**	2,874

8 Reconciliation of adjusted profit before tax

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	£m	£m	**£m**	£m
Reported profit before tax	**563**	499	**1,109**	948
Specific items (Note 4)	**127**	110	**219**	256
Adjusted profit before tax	**690**	609	**1,328**	1,204

9 Reconciliation of adjusted earnings per share

	Second quarter to 30 September		Half year to 30 September	
	2014	2013	**2014**	2013
	pence per share		pence per share	
Reported earnings per share	**5.6**	7.8	**11.2**	12.2
Per share impact of specific items	**1.3**	(1.8)	**2.2**	(0.3)
Adjusted earnings per share	**6.9**	6.0	**13.4**	11.9

10 Pensions

	30 September 2014	30 June 2014	31 March 2014
	£bn	£bn	£bn
IAS 19 liabilities - BTPS	**(47.9)**	(47.0)	(46.7)
Assets - BTPS	**40.8**	40.0	39.9
IAS 19 deficit - other schemes	**(0.2)**	(0.2)	(0.2)
Total IAS 19 deficit, gross of tax	**(7.3)**	(7.2)	(7.0)
Total IAS 19 deficit, net of tax	**(5.9)**	(5.8)	(5.6)
Discount rate (nominal)	3.90%	4.15%	4.25%
Discount rate (real)	0.82%	0.92%	0.97%
RPI inflation	3.05%	3.20%	3.25%
CPI inflation	1.0% below RPI until 31 March 2016 and 1.2% below RPI thereafter	1.0% below RPI until 31 March 2016 and 1.2% below RPI thereafter	0.75% below RPI until 31 March 2016 and 1.2% below RPI thereafter

11 Financial instruments and risk management

Fair value of financial assets and liabilities measured at amortised cost

At 30 September 2014, the fair value of loans and borrowings was £10,919m (31 March 2014: £10,883m) and the carrying value was £9,241m (31 March 2014: £9,814m).

The fair value of the following financial assets and liabilities approximate their carrying amount:

- Cash and cash equivalents
- Trade and other receivables
- Trade and other payables
- Provisions
- Investments classified as loans and receivables

The group's activities expose it to a variety of financial risks: market risk (including interest rate risk and foreign exchange risk); credit risk; and liquidity risk. There have been no changes in our risk management policy since 31 March 2014.

The group's hedging policies use derivative financial instruments to manage financial risk. Our hedging activity seeks to protect against changes in the fair value of fixed-rate long term financial instruments due to movements in market interest rates and to reduce the variability in future interest and currency cash flows on assets and liabilities which bear interest at variable rates and/or are in a foreign currency.

Fair value estimation

Financial instruments measured at fair value consist of derivative financial instruments and investments classified as available-for-sale or designated at fair value through profit and loss. These instruments are further analysed by three levels of valuation methodology which are:

- Level 1 – uses quoted prices in active markets for identical assets or liabilities
- Level 2 – uses inputs for the asset or liability other than quoted prices, that are observable either directly or indirectly
- Level 3 – uses inputs for the asset or liability that are not based on observable market data, such as internal models or other valuation methods.

The fair value of the group's outstanding derivative financial assets and liabilities were estimated using discounted cash flow models and market rates of interest and foreign exchange at the balance sheet date.

11 Financial instruments and risk management (continued)

30 September 2014	Level 1 £m	Level 2 £m	Level 3 £m	Total held at fair value £m
Investments				
Available-for-sale	20	1,152	10	**1,182**
Fair value through profit and loss	8	-	-	**8**
Derivative assets				
Designated in a hedge	-	603	-	**603**
Fair value through profit and loss	-	115	-	**115**
Total assets	**28**	**1,870**	**10**	**1,908**
Derivative liabilities				
Designated in a hedge	-	625	-	**625**
Fair value through profit and loss	-	199	-	**199**
Total liabilities	**-**	**824**	**-**	**824**

31 March 2014	Level 1 £m	Level 2 £m	Level 3 £m	Total held at fair value £m
Investments				
Available-for-sale	18	1,774	7	1,799
Fair value through profit and loss	9	-	-	9
Derivative assets				
Designated in a hedge	-	534	-	534
Fair value through profit and loss	-	119	-	119
Total assets	**27**	**2,427**	**7**	**2,461**
Derivative liabilities				
Designated in a hedge	-	588	-	588
Fair value through profit and loss	-	230	-	230
Total liabilities	**-**	**818**	**-**	**818**

No gains or losses have been recognised in the income statement in respect of Level 3 assets held at 30 September 2014. There were no changes to the valuation methods or transfers between levels 1, 2 and 3 during the half year.

12 Share capital

In the half year to 30 September 2014 320m shares (HY 2013/14: 91m) at a total cost of £941m (HY 2013/14: £248m), calculated at a weighted average cost per share, were transferred from Own shares to satisfy obligations under all-employee and executive share plans. We received cash proceeds of £192m (HY 2013/14: £52m).

The majority of the shares issued were to satisfy the 1 August 2014 maturity of a five year 'saveshare' plan in which nearly 23,000 individuals had participated since 2009.

13 Capital commitments

Capital expenditure for property, plant and equipment and software contracted for at the balance sheet date but not yet incurred was £469m (30 September 2013: £406m; 31 March 2014: £400m).

14 Principal risks and uncertainties

We have processes for identifying, evaluating and managing our risks. Details of our principal risks and uncertainties can be found on pages 50 to 55 of the Annual Report & Form 20-F 2014 and are summarised below. All of them have the potential to have an adverse impact on our business, revenue, profits, assets, liquidity and capital resources.

- The risks that could impact the security of our data or the resilience of our operations and services
- The risks associated with complex and high value national and multinational customer contracts
- The risks associated with a significant funding obligation in relation to our defined benefit pension scheme
- The risks arising from operating in markets which are characterised by: high levels of change; strong and new competition; declining prices and in some markets declining revenues; technology substitution; market and product convergence; customer churn; and regulatory intervention to promote competition and reduce wholesale prices
- The risks associated with some of our activities being subject to significant price and other regulatory controls
- The risks associated with operating under a wide range of local and international anti-corruption and bribery laws, trade sanctions and import and export controls
- The risk there could be a failure of any of our critical third-party suppliers to meet their obligations

There have been no significant changes to the principal risks and uncertainties in the half year to 30 September 2014, some or all of which have the potential to impact our results or financial position during the remaining six months of the financial year.