NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1 Basis of preparation and accounting policies

The final results for the year to 31 March 2015 have been extracted from the audited consolidated financial statements which have not yet been delivered to the Registrar of Companies but are expected to be published on 21 May 2015. The financial statements for the fourth quarter to 31 March 2015 are unaudited.

The financial information set out above does not constitute the company's statutory accounts for the years to 31 March 2015 or 2014 but is derived from those accounts. The auditors have reported on those accounts; their reports (i) were unqualified, (ii) did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and (iii) did not contain a statement under section 498 (2) or (3) of the Companies Act 2006 in respect of the accounts for the year to 31 March 2015 or 31 March 2014. 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.

Changes in presentation and restatement of the financial statements

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 simplifies the way we provide integrated collaboration solutions to our global customers, and helps us 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 the line of business results for the quarter ending 31 March 2014 was to increase revenue, EBITDA and operating cash flow in BT Global Services by £70m, £33m and £42m respectively and to reduce revenue, EBITDA and operating cash flow in BT Business by £74m, £25m and £25m respectively. Central group functions revenue, EBITDA and operating cash flow reduced by £31m, £8m and £17m respectively. Intra-group eliminations on revenue decreased by £35m.

The impact on line of business results for the year ending 31 March 2014 was to increase revenue, EBITDA and operating cash flow in BT Global Services by £228m, £109m and £110m respectively and to reduce revenue, EBITDA and operating cash flow in BT Business by £296m, £96m and £93m respectively. Central group functions revenue, EBITDA and operating cash flow reduced by £49m, £13m and £17m respectively. Intra-group eliminations on revenue decreased by £133m.

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.

2 Operating results – by line of business[1]

	External revenue £m	Internal revenue £m	Group revenue £m	Group EBITDA £m	Group operating profit £m
Fourth quarter to 31 March 2015					
BT Global Services	**1,781**	**8**	**1,789**	**347**	**219**
BT Business	**696**	**109**	**805**	**277**	**233**
BT Consumer	**1,083**	**17**	**1,100**	**317**	**258**
BT Wholesale	**571**	**-**	**571**	**174**	**121**
Openreach	**499**	**767**	**1,266**	**698**	**366**
Other and intra-group items[2]	**9**	**(901)**	**(892)**	**6**	**(28)**
Total	**4,639**	**-**	**4,639**	**1,819**	**1,169**
Fourth quarter to 31 March 2014					
BT Global Services[3]	1,919	8	1,927	319	162
BT Business[3]	715	106	821	262	219
BT Consumer	1,054	14	1,068	269	213
BT Wholesale	571	-	571	152	93
Openreach	468	803	1,271	694	357
Other and intra-group items[2,3]	21	(931)	(910)	9	10
Total	4,748	-	4,748	1,705	1,054
Year to 31 March 2015					
BT Global Services	**6,750**	**29**	**6,779**	**1,047**	**528**
BT Business	**2,746**	**399**	**3,145**	**1,041**	**861**
BT Consumer	**4,223**	**62**	**4,285**	**1,031**	**813**
BT Wholesale	**2,157**	**-**	**2,157**	**561**	**337**
Openreach	**1,947**	**3,064**	**5,011**	**2,600**	**1,252**
Other and intra-group items[2]	**28**	**(3,554)**	**(3,526)**	**(9)**	**(58)**
Total	**17,851**	**-**	**17,851**	**6,271**	**3,733**
Year to 31 March 2014					
BT Global Services[3]	7,238	31	7,269	1,041	425
BT Business[3]	2,798	415	3,213	1,002	805
BT Consumer	3,970	49	4,019	833	614
BT Wholesale	2,422	-	2,422	614	369
Openreach	1,822	3,239	5,061	2,601	1,195
Other and intra-group items[2,3]	37	(3,734)	(3,697)	25	13
Total	18,287	-	18,287	6,116	3,421

[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

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	£m	£m	**£m**	£m
Direct labour costs	**1,093**	1,177	**4,545**	4,689
Indirect labour costs	**184**	205	**774**	848
Leaver costs	**4**	4	**8**	14
Total labour costs	**1,281**	1,386	**5,327**	5,551
Capitalised labour	**(349)**	(253)	**(1,143)**	(996)
Net labour costs	**932**	1,133	**4,184**	4,555
Payments to telecommunications operators	**512**	567	**2,144**	2,472
Property and energy costs	**245**	204	**968**	959
Network operating and IT costs	**140**	136	**605**	591
Programme rights charges	**85**	77	**330**	203
Other costs	**906**	926	**3,349**	3,391
Operating costs before depreciation, amortisation and specific items	**2,820**	3,043	**11,580**	12,171
Depreciation and amortisation	**650**	651	**2,538**	2,695
Total operating costs before specific items	**3,470**	3,694	**14,118**	14,866
Specific items (Note 4)	**177**	94	**381**	276
Total operating costs	**3,647**	3,788	**14,499**	15,142

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.

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	£m	£m	**£m**	£m
Specific revenue				
Retrospective regulatory rulings	**70**	-	**128**	-
Specific operating items				
Restructuring charges	**157**	94	**315**	276
Property rationalisation costs	**45**	-	**45**	-
Profit on disposal of property	**(67)**	-	**(67)**	-
Loss (profit) on disposal of businesses	**1**	-	**(6)**	-
Retrospective regulatory matters	**22**	-	**75**	-
EE related acquisition costs	**19**	-	**19**	-
Specific operating costs	**177**	94	**381**	276
EBITDA impact (Note 7)	**107**	94	**253**	276
Net interest expense on pensions	**74**	59	**292**	235
EE related financing costs	**7**	-	**7**	-
Loss (profit) on disposal of interest in associates and joint ventures	**-**	1	**(25)**	4
Net specific items charge before tax	**188**	154	**527**	515
Tax credit on specific items before tax	**(53)**	(33)	**(121)**	(111)
Tax charge (credit) on re-measurement of deferred tax	**-**	23	**-**	(208)
Net specific items charge after tax	**135**	144	**406**	196

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.

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	£m	£m	**£m**	£m
Cash generated from operations	**1,266**	1,730	**5,105**	5,143
Tax paid	**(23)**	(131)	**(309)**	(347)
Net cash inflow from operating activities	**1,243**	1,599	**4,796**	4,796
Add back pension deficit payments	**876**	325	**876**	325
Included in cash flows from investing activities				
Net purchase of property, plant and equipment and software	**(699)**	(544)	**(2,318)**	(2,346)
Interest received	**3**	2	**10**	6
Sales of non-current financial assets	**2**	3	**8**	4
Included in cash flows from financing activities				
Interest paid	**(108)**	(112)	**(590)**	(614)
Reported free cash flow	**1,317**	1,273	**2,782**	2,171
Net cash outflow from specific items	**3**	92	**154**	356
Cash tax benefit of pension deficit payments	**(53)**	(19)	**(106)**	(77)
Normalised free cash flow	**1,267**	1,346	**2,830**	2,450

6 Net debt

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

	At 31 March	
	2015	2014
	£m	£m
Loans and other borrowings[1]	**9,768**	9,814
Cash and cash equivalents	**(434)**	(695)
Current asset investments	**(3,523)**	(1,774)
	5,811	7,345
Adjustments:		
To re-translate currency denominated balances at swapped rates where hedged	**(357)**	(24)
To remove fair value adjustments and accrued interest applied to reflect the effective interest method	**(335)**	(293)
Net debt	**5,119**	7,028

[1] Includes overdrafts of £27m at 31 March 2015 (31 March 2014: £11m)

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

Earnings before interest, tax, 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.

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	£m	£m	**£m**	£m
Reported profit before tax	**842**	747	**2,645**	2,312
Share of post tax losses of associates and joint ventures	**1**	-	**1**	3
Loss (profit) on disposal of interest in associates and joint ventures	**-**	1	**(25)**	4
Net finance expense	**219**	212	**859**	826
Operating profit	**1,062**	960	**3,480**	3,145
Depreciation and amortisation	**650**	651	**2,538**	2,695
Reported EBITDA	**1,712**	1,611	**6,018**	5,840
Specific items (Note 4)	**107**	94	**253**	276
Adjusted EBITDA	**1,819**	1,705	**6,271**	6,116

8 Reconciliation of adjusted profit before tax

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	£m	£m	**£m**	£m
Reported profit before tax	**842**	747	**2,645**	2,312
Specific items (Note 4)	**188**	154	**527**	515
Adjusted profit before tax	**1,030**	901	**3,172**	2,827

9 Reconciliation of adjusted earnings per share

	Fourth quarter to 31 March		Year to 31 March	
	2015	2014	**2015**	2014
	pence per share		pence per share	
Reported basic earnings per share	**8.4**	7.2	**26.5**	25.7
Per share impact of specific items	**1.6**	1.8	**5.0**	2.5
Adjusted earnings per share	**10.0**	9.0	**31.5**	28.2

10 Pensions

	31 March 2015 £bn	31 March 2014 £bn
IAS 19 liabilities - BTPS	**(50.7)**	(46.7)
Assets – BTPS	**43.4**	39.9
Other schemes	**(0.3)**	(0.2)
IAS 19 deficit, gross of tax	**(7.6)**	(7.0)
IAS 19 deficit, net of tax	**(6.1)**	(5.6)
Discount rate (nominal)	3.25%	4.25%
Discount rate (real)	0.39%	0.97%
RPI inflation	2.85%	3.25%
CPI inflation	1.0% below RPI until 31 March 2017 and 1.2% below RPI thereafter	0.75% below RPI until 31 March 2016 and 1.2% below RPI thereafter

11 Principal risks and uncertainties (extracted from the BT Group plc Annual Report & Form 20-F 2015)

Principal risks and uncertainties

In this section we explain some of the principal risks and uncertainties affecting us. These risks have the potential to impact our business, brand, people, assets, revenue, profits, liquidity or capital resources. The principal risks we described last year have evolved, and so too has our response to them.

Our Enterprise Risk Management framework provides reasonable (but cannot give absolute) assurance that significant risks are identified and addressed. There may be some risks which are unknown to us at present. And there may be some that we consider less significant now but become more important later.

External factors can present both risks and opportunities, to our business and to others. We focus our efforts on predicting and mitigating the risks, while at the same time seeking to capitalise on opportunities that may emerge.

We recognise the particular uncertainty that political and geo-political risks present, both in the UK (for example the Scottish independence referendum in 2014) and globally. We now monitor these through a separate sub-committee of our Group Risk Panel.

In the principal risks section below, we talk about what we are doing to stop our main risks materialising, or to limit their impact. Our principal risks and uncertainties should be considered along with the risk management process, the forward-looking statements in this document and the cautionary statement regarding forward-looking statements, which you can read below.

Our principal risks

Security and resilience

The resilience of our IT systems, networks and associated infrastructure, including our core data centres and exchanges, is essential to our short and long-term commercial success. We face a variety of hazards that could cause significant interruptions to the delivery of our services. These include component failure, physical attack, theft of copper cable and equipment, fire, explosion, flood, power failure, overheating or extreme cold, problems encountered during upgrades and major changes, and the failure of key suppliers. A cyber-security incident or logical attack could also be the trigger for service interruption.

We also have a responsibility to many millions of customers, both business and consumer, to ensure their electronic information remains confidential, accurate, secure and available. The same holds true for our own data, information and intellectual property.

Impact
A breach of our security, or compromise of data or resilience affecting our operations, or those of our customers, could lead to an extended interruption to our services or even affect national infrastructure. The impact of such a failure could include: immediate financial losses due to fraud and theft; termination of contracts; immediate loss of revenue where orders and invoices cannot be processed; contractual penalties; lost productivity and unplanned costs of restoration and improvement; prosecution; and fines. Additionally, reputational damage may arise, undermining market confidence and jeopardising future revenues. Ultimately the welfare of individuals might be put at risk where services cannot be provided or personal data is misappropriated.

Changes over the last year
In the past year we have had to deal with an unprecedented increase in the volume and intensity of cyber-attacks. We recorded more top priority incidents in the last three months of 2014 than were experienced in the previous two years. The attacks were aimed not just at BT, but also at our customers, with the potential to disrupt others and cause collateral damage to BT services.

Following a comprehensive review of the resilience and disaster recovery capability of our critical systems, databases and exchanges, we have invested in enhancing site resilience based on our target levels of acceptable risk. We have also invested significantly in geo-resilience (i.e. cross-site recovery) for our critical systems where this did not previously exist, and have already seen a return on this investment through seamless failover and continuity of service during planned and, occasionally, unplanned outages.

Risk mitigation
We manage the risk of service interruption through a robust control framework that focuses first and foremost on prevention, supported by tried-and-tested recovery capabilities. We have also undertaken a large-scale estate resilience programme during the year, through which we have continued to invest in developing our resilience and recovery capabilities in instances where the risk has been shown to exceed acceptable levels for us. We have a rolling programme of major incident simulations to test and refine our crisis management procedures. An intensive focus on controlling the volume of network changes has also reduced the number of incidents.

The replacement of equipment that is approaching the end of its service life has provided opportunities to invest in new, more resilient facilities. We also benefit from having geographically-distributed locations that support cross-site recovery, avoiding the need to invest in new sites just for this purpose.

Our security strategy aims to prevent, deter and minimise the consequences of attacks. Our defences include physical protection of our assets, encryption of data, control of access rights, real-time analysis and sharing of intelligence, and continuous monitoring for intrusion, modifications and anomalies. We can rapidly adjust firewalls to automatically block most malicious data traffic. These measures combine to reduce the likelihood of a major incident and help ensure that interruption or damage can be contained and dealt with promptly and effectively.

In response to the increased cyber threat, we have strengthened our defences, invested in new tools, techniques and skills to monitor threats, and increased our capacity to deal with attacks. We have also started a major programme to restructure our IT estate to make it quicker and easier to manage the incidents when they occur.

Major contracts

We have a number of complex and high-value national and multinational customer contracts. The revenue arising from, and the profitability of, these contracts are subject to a number of factors including: variation in cost; achievement of cost reductions anticipated in the contract pricing, both in terms of scale and time; delays in the delivery or achievement of agreed milestones owing to factors either within or outside of our control; changes in customers' requirements, their budgets, strategies or businesses; and the performance of our suppliers. Any of these factors could make a contract less profitable or even loss-making.

The degree of risk generally varies with the scope and life of the contract and is typically higher in the early stages of the contract. Some customer contracts require investment in the early stages, which is expected to be recovered over the life of the contract.

Major contracts often involve the implementation of new systems and communications networks, transformation of legacy networks and the development of new technologies.

The recoverability of these upfront costs may be impacted by delays or failure to meet milestones. Substantial performance risk exists in some of these highly complex contracts.

Impact

Failure to manage and meet our commitments under these contracts, as well as changes in customers' requirements, their budgets, strategies or businesses, may lead to a reduction in our expected future revenue, profitability and cash generation. Unexpectedly high costs associated with the delivery of particular transformational contracts could also negatively impact profitability.

Earnings may be reduced or contracts may even become loss-making through loss of revenue, changes to customers' businesses, business failure or contract termination. Failure to replace the revenue and earnings lost from such customers could lead to an overall reduction in group revenue, profitability and cash flow.

Changes over the last year

Tough market conditions and competitive pressures continue in many global regions while in some we are experiencing higher growth in volume of business due to previous investments we have made. The risk landscape changes accordingly, as does our focus of risk support and review.

Of particular note in this year has been the number of broadband contracts with local authorities through the BDUK programme now entering the delivery phase of the contract lifecycle. While these contracts carry a different risk profile, we apply our established risk governance and reporting processes to ensure that risks and mitigation activities are identified and reported to management.

Risk mitigation

Our group-wide risk governance and reporting, along with line of business local governance and risk management processes, provide the visibility of key risk and mitigation activities. Assurance is provided via independent audits and at an individual contract level through an independent review programme based on multiple selection criteria or by senior management request. Progress on risks and mitigation actions agreed at such independent reviews are monitored and reported to relevant senior managers to ensure progress can be tracked. A separate, dedicated team provides assurance over our BDUK programme.

We have skills development programmes to enhance the ability of our people to identify and manage risk and to make sure learning from previous experience is included in training materials. The scope and availability of training opportunities continue to grow in line with BT-wide learning and development initiatives.

Pensions

We have a significant funding obligation in relation to our defined benefit pension scheme in the UK, the BT Pension Scheme (BTPS or Scheme). The BTPS faces similar risks to other defined benefit schemes. Future low investment returns, lower interest rates, high inflation, longer life expectancy and regulatory changes may all result in the cost of funding the BTPS becoming a more significant burden on our financial resources.

Impact

The next valuation of the BTPS is scheduled to take place as at 30 June 2017 and an increase in the pension deficit may have an impact on the level of deficit payments we are required to make into the Scheme. Indirectly it may also have an adverse impact on our share price and credit rating.

Any deterioration in our credit rating would increase our cost of borrowing and may limit the availability or flexibility of future funding for the group, thereby affecting our ability to invest, pay dividends or repay debt as it matures.

Changes over the last year

The actuarial valuation of the Scheme as at 30 June 2014 was announced on 30 January 2015. This has provided certainty over the level of cash contributions required until the next triennial valuation is concluded.

When a valuation is calculated, the funding position is affected by the financial market conditions at the valuation date. When determining expected future returns on the Scheme assets, different factors are taken into account, including yields (or returns) on government bonds, which have fallen significantly since 30 June 2014. If a lower investment return assumption is adopted at the 30 June 2017 valuation, the liabilities would likely increase, potentially leading to a higher level of deficit payments.

The BTPS entered into longevity insurance and reinsurance arrangements on 4 July 2014 to help protect the Scheme against costs associated with potential increases in life expectancy. These arrangements covered approximately 25% of the Scheme's total exposure to increases in longevity.

On 16 July 2014 the Court of Appeal handed down its judgment on the scope and extent of the Crown Guarantee, which was granted by the Government on BT's privatisation. This judgment has provided welcome clarity although the Crown Guarantee is not taken into account for the purposes of the actuarial valuation of the Scheme and is an entirely separate matter, only being relevant in the highly unlikely event that BT became insolvent.

Risk mitigation
The investment performance and liability experience, as well as the associated risks and any mitigation, are regularly reviewed and monitored by both us and the BTPS Trustee. The BTPS has a well-diversified investment strategy, which reduces the impact of adverse movements in the value of individual asset classes and helps ensure that an efficient balance of risk and return is maintained.

Our financial strength and cash generation provide a level of protection against future variations in the funding position of the BTPS. The funding liabilities also include some buffer against any future negative experience, as legislation requires that liabilities are calculated on a prudent basis.

Growth in a competitive market

We operate 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.

Impact
Failure to achieve sustainable, profitable revenue growth could erode our competitive position and reduce our profitability, cash flow and ability to invest for the future.

Changes over the last year
The UK economy grew by 3% in 2014; however, customers are cautious with their spending. Price and value for money remain the main decision drivers for many consumers and small businesses. At a global level, continuing economic uncertainty remains a factor causing corporate customers to delay or downscale infrastructure upgrades and significant investment decisions.

Competition in our markets is strong. In the UK, new providers of fibre to the premises are entering the fibre access market, by offering alternatives to the Virgin Media and Openreach networks. In the TV and content markets, TV viewing habits are changing with the increasing use of on-demand viewing via over-the-top content services providers.

Fixed-mobile convergence is a trend visible in many Continental European countries and increasingly in UK markets. A number of providers are competing in this space. BT's proposed acquisition of EE may stimulate other operators to react to fixed-mobile convergence provided the UK market develops in this way.

Risk mitigation
Our mitigation of this risk centres on successfully executing our strategy. We believe that delivering this strategy, with its focus on broadening and deepening our customer relationships, delivering superior customer service, transforming our costs and investing for growth, will together help us deliver sustainable, profitable revenue growth. We are investing in our business, in areas such as fibre, TV/content, voice/mobility, UK business markets and through our focus on global companies. Our extensive cost transformation programmes continue to deliver savings and will support profitability trends. We also believe we can mitigate this risk by seeking changes in regulation to level the playing field so that we can compete effectively in adjacent markets for the benefit of our customers.

Communications industry regulation

Regulation impacts our activities across all jurisdictions.

In the UK, Ofcom can require us to provide specific wholesale services on specified terms following market reviews. The scope and form of that regulation is reviewed every three years and can include controls on the level of prices we can charge for regulated inputs. It has powers to investigate and enforce the regulatory rules in place and can impose fines on us for non-compliance. Ofcom also has powers to regulate the terms on which we are supplied with certain services – for instance, mobile call termination and wholesale access to certain pay TV channels – and this impacts our costs and the scope of services we are able to provide to our customers. Ofcom can also resolve disputes between BT and other communications providers about the terms on which services are supplied.

Outside the UK, general licensing requirements can restrict the extent to which we can enter markets and compete. Regulation will also define the terms on which we can purchase key wholesale services from others.

Impact

Regulatory requirements and constraints can directly impact our ability to compete effectively and earn revenues.
Regulatory impacts are highest in the UK where BT is subject to direct regulation in a number of areas following periodic market reviews. Based on the latest Regulatory Financial Statements for 2013/14, around £5.2bn of our revenue (of which £2.8bn is to downstream parts of BT) is from wholesale markets where we have been found to have Significant Market Power following market reviews. Most of these revenues are subject to charge controls which require us to reduce our prices annually by a defined percentage in real terms. Controls are usually set for three years and will constrain revenues during that period.

When other CPs ask Ofcom to resolve disputes with us, there is a risk that Ofcom may set the prices at which services must be supplied and/or require us to provide specific services. In certain circumstances, Ofcom can adjust historic prices and require us to make repayments to CPs.

Regulation outside the UK can impact (i) our revenue, by limiting our ability to compete through overly-restrictive licensing requirements or ineffective regulation of access to other networks and (ii) our costs, by defining and controlling the terms of access to necessary regulated inputs.

Changes over the last year

Over the last year, we have seen regulatory activity in a number of areas which are summarised in Regulation above.

Risk mitigation

We have a team of regulatory specialists (including economists and accountants) who, together with legal experts and external advisers, continuously monitor and review the scope for changes in the regulatory rule set and potential disputes with other CPs. This team maintains an ongoing dialogue with regulators and other key influencers to understand the regulatory outlook and to ensure our positions are understood. We push for fair, proportionate, consistent and evidenced-based regulation across markets and jurisdictions. We actively engage in supplying evidence and analysis for all market reviews, charge controls and disputes/investigations to manage the risks arising from specific decisions in any given year.

We are also able to appeal any regulatory decisions where we believe errors have been made. We will also raise disputes and complaints under the relevant regulatory framework or competition law where we face problems gaining access to wholesale services – such as access to other networks or to wholesale pay-TV channels.

Business integrity and ethics

We are committed to maintaining high standards of ethical behaviour, and have a zero tolerance approach to bribery and corruption. We have to comply with a wide range of local and international anti-corruption and bribery laws. In particular the UK Bribery Act and US Foreign and Corrupt Practices Act (FCPA) provide comprehensive anti-bribery legislation. Both have extraterritorial reach and so cover our global operations. As we expand globally, we are increasingly operating in countries identified as having a higher risk of bribery and corruption. We also have to ensure compliance with trade sanctions, and import and export controls.

Impact

Failure by our employees, or associated persons such as suppliers or agents to comply with anti-corruption and bribery and sanctions legislation could result in substantial penalties, criminal prosecution and significant damage to our reputation. This could in turn impact our future revenue and cash flow, the extent of which would depend on the nature of the breach, the legislation concerned and any associated penalties. Allegations of corruption or bribery or violation of sanctions regulations could also lead to reputation and brand damage with investors, regulators and customers.

Changes over the last year

The importance of conducting business ethically is becoming increasingly recognised across the globe as more countries pass anti-corruption and bribery legislation. In the UK, deferred prosecution agreements are available to the UK Serious Fraud Office for fraud, bribery and other economic crime. In terms of enforcement, there are yet to be any significant cases resulting from the UK Bribery Act, but there continue to be many significant enforcement actions brought under the FCPA.

Risk mitigation
We have in place a number of controls to address risk in this area. These include a comprehensive anti-corruption and bribery programme, and 'The Way We Work', which is our statement of business practice, and which is available in 14 languages. We ask all BT employees to sign up to its principles and our anti-corruption and bribery policy. We have specific policies covering gifts and hospitality and charitable donations and sponsorship. We run a training programme with a particular focus on roles such as those in procurement and sales.

We regularly assess our business integrity risks to make sure that the appropriate mitigation is in place. 'Speak Up' is our confidential hotline, which is operated by an external third party with all reports passed to the Director of Ethics and Compliance for review and investigation. Our internal audit team regularly runs checks on our business. We also use external providers to carry out assessments in areas we believe to be higher risk, to ensure our policies are understood and the controls are functioning. We selectively conduct due diligence checks on third parties including suppliers, agents, resellers and distributors. Our procurement contracts include anti-corruption and bribery clauses.

We have implemented a policy to adhere to applicable sanctions and export control laws. The policy requires approval on all contract bids involving a country where sanctions are imposed by the EU or the US. The policy also mandates that our internal shipping system is used to arrange all international exports. The system conducts compliance checks and flags any orders which require an export licence.

Supply chain

We operate in a global supply market. This enables us to procure third-party products and services that help us deliver to our customers wherever they are. There are often several links in the 'chain' of supply of a product or service to us. The integrity and continuity of this supply chain is critical to our operations and therefore a significant risk to our business.

We are committed to ensuring that all dealings with suppliers, from selection and consultation through to contracting and payment, are conducted in accordance with our trading and ethical policies.

We have a number of suppliers that we have identified as critical. The failure of one of these suppliers to meet its obligations could cause significant harm to our business.

We are committed to evaluating and responding to any associated risks where geo-political and market forces could impact our suppliers' ability to support BT.

Impact
While the size of the impact from a supplier failure can vary, all supplier failures typically result in an increased cost to our business and have the potential to adversely impact customer service, our investments and our brand. In many cases, the costs associated with the failure of a critical supplier could be significant, particularly if this means we have to change technology. If we are unable to contract with an alternative supplier, our customer commitments could also be compromised, possibly leading to contractual breach, loss of revenue or penalties.

We are continually testing the global market for new sources of supply; but this brings its own challenge of suppliers becoming more geographically and culturally diverse from our customers.

A failure in our supply chain to meet legal obligations or ethical expectations could adversely impact our reputation or possibly lead to censure, legal action and financial loss.

Changes over the last year
We have increased our focus on category management of suppliers. Category management is a process that means our buyers can consolidate specific categories of spend across all our businesses, so we can maximise the operational and procurement synergies. It helps mitigate the risk of BT not reaching its cost transformation objectives by enabling us to leverage better deals with our suppliers; and to intercept purchase orders where better terms are available elsewhere.

Increased focus on in-life contract management of our critical suppliers is delivering benefits in terms of improved supplier contract performance and risk control.

Risk mitigation
We conduct supplier risk analysis as part of our sourcing strategy, and where possible, take actions to reduce risk, such as through dual sourcing.

We undertake on-site supplier assessments, to evaluate the risks associated with a supplier's capability, capacity and competence to meet our requirements in a predictable, ethical and sustainable manner.

BT operates a comprehensive in-life risk management process called 'Supplier watch' that recognises the supplier's criticality to our strategy and operations; and scans for changes across a range of commercial, financial, operational and reputational risks. We check that the appropriate level of supplier governance is in place across the group; and test that appropriate business continuity arrangements are in place for the risk of supplier failure. Over 330 critical suppliers, as nominated by the operational owners of the business units that depend on them, are covered by the process.

We look for signs of supplier distress that enable us to mitigate the risk before it materialises. A small number of our critical suppliers fell into administration in 2014/15, but, in each case, we were appropriately prepared with a business plan that minimised disruption to our customers.

Socio-political, economic and environmental conditions in certain markets and geographies continue to challenge some of our suppliers; and highlight the need for appropriate due diligence across our supply chain.

Protecting our brand from events in the supply chain, such as corrupt practices, the sourcing of conflict minerals or possible human rights abuse, continues to demand a high degree of focus.

Customer data processing

As a major data controller and processor of customer information around the world we recognise the importance of adhering to data privacy laws. Every day we process the personal data of millions of consumer and business customers and we want individuals to feel confident that when they give their personal data to us they can trust us to do the right thing with it.

Being trusted with customer data goes further than making sure it is secure. It is about ensuring the integrity of the personal data we process, only retaining the information that we need to provide customers with the services for which they have signed up. It is also about being transparent around how we use that data, making sure the personal data is processed legally, fairly and in line with customers' rights and wishes. Through embedding a robust data governance framework we have reinforced our expectations around personal data with our employees, partners and third parties.

As a telecommunications and internet service provider we operate under a stringent 24-hour reporting regime to notify the UK Information Commissioner's Office (ICO) should we become aware of a personal data security breach and to notify those individuals who may have been impacted without undue delay.

Impact
Failure to comply with relevant data protection and privacy laws could result in varying degrees of negative impact for BT. These include the possibility of regulatory enforcement action, fines, class actions, custodial sentences and a regulatory instruction to cease processing data.

We could also face reputational damage and financial loss from the failure to meet our legal requirements, as well as incurring costs resulting from termination of customer contracts and subsequent customer churn. Companies, such as Sony which has suffered high profile data incidents, have seen a significant negative impact on their share price combined with additional costs associated with non-compliance.

Changes over the last year
National regulatory authorities have demonstrated an increasingly aggressive stance over the last 12 months with the application of financial penalties to both private and public organisations in breach of their data privacy obligations.

For the first time in the UK, the ICO imposed more fines than Ofcom. Outside the UK, global organisations felt the force of their domestic regulators with notably the French information commissioner (CNIL) and the US Federal Communications Commission's Enforcement Bureau imposing significant penalties on organisations for poor compliance practices.

The sensitivity of this risk is expected to increase as new, more robust data privacy laws are introduced throughout the scope of our operations. The continuing debate around the future EU General Data Protection Regulation is already influencing how multinational businesses address this risk.

Risk mitigation

We have a Privacy & Data Governance team which is led by the Chief Privacy Officer and has continued to recruit individuals with the appropriate skills and experience as the remit of this team expands.

The Chief Privacy Officer oversees a robust governance and monitoring framework. This defines roles and responsibilities as part of a wider approach to data assurance which utilises independent audits and reviews. We track all mitigations to resolution to ensure that senior management are aware of the risk and how it impacts respective parts of our business.

We have developed new online tools and awareness programmes to make sure that our people comply in their day-to-day activities where they handle personal information. In addition to raising awareness of Privacy by Design, an approach to projects that promotes privacy and data protection compliance from the start, we have also deployed Privacy Impact Assessment tools as part of the design process around new products and services.

Our focus on broader training and awareness will see a new data privacy module, which our people will need to complete, deployed with role-specific scenarios for specific job families. As part of this bespoke approach to managing the risk, for the first time we will have a module designed specifically for the contact centre environment to highlight the diverse number of responsibilities our contact centre people have when dealing with customer data.

EE acquisition: Risks

Our proposed acquisition of EE creates additional risks for BT beyond those captured in our principal risks and uncertainties. In the section below we highlight those risks relating to the acquisition, and new risks that would be relevant to the enlarged group. We disclosed these risks in the shareholder circular published on 1 April 2015 and have reproduced them below.

Risks related to the acquisition

In the period through to completion of the acquisition there are risks relating to the deal itself, as well as business risks during this transitional phase.

Approval of the acquisition

Completion of the acquisition is conditional upon satisfaction or, where capable of being waived, waiver of various conditions. In the event that these conditions are not satisfied or, where they can be waived, waived by the 'long stop date' (or a later date which we agree with the sellers), the Share Purchase Agreement will automatically terminate. There can be no assurance that the conditions will be fulfilled or waived, or that the acquisition will be completed.

The acquisition is subject to merger control approval from the Competition and Markets Authority (CMA) in the UK. Approval from the CMA may take longer than expected to obtain, may not be granted, or may be granted subject to conditions or remedies, including BT or EE's divestment of assets or businesses and/or restrictions on the conduct of the enlarged group. Any of these could delay or jeopardise completion, impose sustained additional costs for the enlarged group and/or materially reduce the anticipated benefits (including synergy benefits) of the acquisition, or result in a material adverse effect on the enlarged group's business, financial condition and results of operations.

EE's performance prior to completion of the acquisition

The anticipated benefits and synergies of the acquisition have been developed based on assumptions regarding (among other things), EE's financial and operational performance, including in the period before completion when EE's performance is outside our control. During this time, EE's performance – and that of BT – could be negatively impacted by one or more of the following:

- an adverse event, or events, affecting EE which would not give rise to a right of BT to terminate the acquisition;
- as a result of the acquisition, some of BT's or EE's customers or strategic partners may terminate or reduce their business relationships with the enlarged group, for example to avoid sourcing too great a proportion of services from a single company;
- potential customers of BT or EE may delay entering into, or decide not to enter into, a business relationship with BT or EE until completion because of perceived uncertainty over the acquisition;
- EE may fail to retain key personnel and other employees; and
- third parties may terminate or alter existing contracts with EE as a result of the acquisition, in particular where 'change of control' or similar clauses apply.

If any of these happen, the value of EE may be less than the consideration paid by BT and, accordingly, the net assets of the enlarged group could be reduced. This could have a material adverse effect on the enlarged group's financial position.

Realising synergies following integration

BT is targeting significant synergies from the acquisition. The financial planning for the enlarged group is based partly on realising these synergies, which include expected operating cost savings and capital expenditure savings of £360m per year, to be realised in the fourth full year following completion. Combining the respective businesses is also expected to give rise to further benefits. These include (among other things), fixed-mobile convergence, the ability to serve customers through a single, seamless platform supported by a single IP network, and being able to offer BT products to EE customers and EE products to BT customers.

The success of the enlarged group will depend, in part, on the effectiveness of the integration process and the ability to realise the anticipated benefits and synergies from combining the businesses.
Some of the potential challenges in combining the businesses may not be known until after completion. If these challenges cannot be overcome, for example because of unforeseen difficulties in implementing fixed-mobile convergence or a lack of customer demand for the offerings, the anticipated benefits of the acquisition will not be fully achieved.

Realisation of synergies will depend partly on the rapid and efficient management and co-ordination of the activities of the enlarged group's businesses. We may experience difficulties in integrating EE with our existing businesses and may not realise, or it might take longer than expected to realise, certain or all of the perceived benefits of the acquisition. There is also a risk that synergy benefits and growth opportunities from the acquisition may fail to materialise, or may be materially lower than have been estimated. In addition, the costs of generating these synergies, which are expected to be around £600m, may exceed expectations.

Failure to deliver the anticipated synergies and business opportunities could have a material adverse effect on the enlarged group's businesses, financial conditions and results of operations, including its ability to support its pension deficit.

Increased cost of debt

The enlarged group may face increased costs when it seeks to refinance or repay its debt as a result of its increased level of debt following the acquisition.

The acquisition will be funded in part by a £3.6bn debt bridge facility, which may be extended for an additional 12 months following its one year maturity.

The costs and other terms on which the enlarged group is able to refinance the debt bridge facility and other longer-term indebtedness will depend partly on market conditions; unfavourable economic conditions could impact the cost and terms on which the enlarged group is able to access capital markets to refinance its indebtedness which may increase its cost of capital.

Risks to the enlarged business

Although a number of the risks EE faces are similar in nature to those potentially impacting BT today, there are also a number of distinct risks that the enlarged group will face that we do not currently perceive to be significant threats to BT.

This section outlines some of those new risks and uncertainties, but it is not exhaustive. These risks have the potential to impact the enlarged group's business, brand, assets, revenue, profits, liquidity or capital resources.

Our Enterprise Risk Management framework will continue to operate in the enlarged group and provides reasonable (but cannot give absolute) assurance that significant risks are identified and addressed. There may be some risks which are unknown to us at present. And there may be some that we consider less significant now but become more important later.

Handset and network development

The enlarged group's operations will depend partly on the successful deployment of continuously evolving telecommunications technologies.

Delays in the development of handsets and network compatibility and components may hinder the deployment of new technologies for the enlarged group.

EE uses technologies from a number of vendors and incurs significant capital expenditure deploying these technologies. There can be no assurance that common standards and specifications will be achieved, that there will be interoperability across BT's, EE's and other networks, that technologies will be developed according to anticipated schedules, that they will perform according to expectations or that they will achieve commercial acceptance. The introduction of software and other network components may also be delayed. The failure of vendor performance or technology performance to meet our expectations or the failure of a technology to achieve commercial acceptance could result in additional capital expenditure by, or reduction in profitability of, the enlarged group.

Technological change and market acceptance

The enlarged group may not succeed in making customers sufficiently aware of existing and future services or in creating customer acceptance of these services at the prices we would want to charge. Also, the enlarged group may not identify trends correctly, or may not be able to bring new services to market as quickly or price-competitively as its competitors.
These risks exist in the mobile telecommunications area (such as mobile data services or other advanced technologies which are supported by advanced smartphone products). They also exist in the non-mobile telecommunications areas (such as mobile payment services based on contactless technology) where there is a risk that differences in the regulatory treatment of different operators based on their choice of technology could put the enlarged group at a competitive disadvantage.

Further, as a result of rapid technological progress and the trend towards technological convergence, new and established information and telecommunications technologies or products may not only fail to complement one another but in some cases, may even become a substitute for one another. An example of this is the risk that 'over the top' services (being those which are provided by a third party to the end user device) develop substitutes for BT's and EE's own products and services. Another example is VoIP, a technology that is already established in the business customer market and which has now reached the consumer market. The introduction of mobile handsets with VoIP functionality may adversely affect the enlarged group's pricing structures and market share in its mobile voice telephony business. If we do not appropriately anticipate the demand for new technologies, and adapt our strategies, service offering and cost structures accordingly, the enlarged group may be unable to compete effectively, which may have an adverse effect on our business and operations.

Supplier failure

EE has a number of suppliers identified as critical. EE is also party to a complex and critical network-sharing arrangement with Hutchison Whampoa Limited. The failure of this joint operation to fully support the enlarged group's interests and goals, or any material disruption to the operation of EE's network sharing arrangement, could cause significant harm to the enlarged group's business.

As demand for smartphone and tablet products increases around the world, there could be shortages in the volume of devices produced as a result of insufficient manufacturing capacity, the lack of availability of internal components such as processors or major supply chain disruptions. This may result in delays in the supply chain which in turn may have an adverse effect on the enlarged group's business and operations.

Spectrum pricing and regulation

Regulators, including Ofcom, set annual licence fees for spectrum bands used by EE for voice calls, 3G and 4G services and EE is a party to an ongoing consultation with Ofcom in relation to this. Any significant increases in spectrum pricing applicable to the enlarged group could have a material adverse effect on its business and results of operations.

EE will monitor any developments from regulators relating to the allocation of mobile spectrum in the UK.

The scope and form of the regulation of wholesale services is reviewed every three years and can include controls on the level of prices charged for regulated inputs. Ofcom may, after consultation, vary conditions in relation to spectrum licences.

As technology and market dynamics develop and as the mobile business of EE is integrated into BT then a wider range of existing regulations will apply to the enlarged group and a broader range of new and/or modified regulations may be directed at us.

Network and licence investment

EE (as well as BT to a lesser extent), has made substantial investments in the acquisition of licences and EE has invested in its mobile networks, including modernising its 2G network, the upgrade of its 3G network and the continued expansion of its 4G network which was launched in October 2012. EE expects to continue to make significant investments in its mobile networks due to increased usage and the need to offer new services and greater functionality. It may acquire new spectrum licences with licence conditions which may include network coverage obligations or increased licence fees. Accordingly, the rate of the enlarged group's capital expenditure and costs in future years could increase and exceed those expected or experienced to date.

There can be no assurance that new services will be introduced according to anticipated schedules or that the level of demand for new services will justify the cost of setting up and providing new services (in particular, the cost of new spectrum licences and network infrastructure, eg for 4G services and subsequent evolutions). Failure or a delay in completing networks and launching new services, or increases in the associated costs, could have an adverse effect on the enlarged group's business and operations and could result in significant write downs of the value of network spectrum or other licences or other network-related investments.

If the current economic climate worsens, the enlarged group may decide, or be required, to scale back capital expenditure. A lasting reduction in capital expenditure levels below certain thresholds could affect our ability to invest in our mobile telecommunications network (including additional spectrum), new technology and our other businesses and therefore could have an adverse effect on our future growth and the value of radio spectrum.

Transmission of radio waves

Media reports have suggested that radio frequency emissions from wireless mobile devices and mobile telecommunications sites may cause health issues, including cancer, and may interfere with some electronic medical devices, including hearing aids and pacemakers. Research and studies are ongoing. The World Health Organisation has declared that, on the basis of current scientific knowledge, there are no known adverse effects on health from emissions at levels below internationally recognised health and safety standards. However, the enlarged group cannot provide assurance that research in the future will not establish links between radio frequency emissions and health risks.

Whether or not research or studies conclude that there is a link between radio frequency emissions and health, popular concerns about radio frequency emissions may discourage the use of wireless devices, impairing the enlarged group's ability to retain customers and attract new customers, and may result in restrictions on the location and operation of mobile communications sites and the usage of the enlarged group's wireless technology. These concerns could also lead to litigation against the enlarged group. Any restrictions on use or litigation could have an adverse effect on the enlarged group's business and operations.