Notes to the financial statements

for the year ended 31 March 2015

02 Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

Basis of accounting

The consolidated and Parent company financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU), IFRIC interpretations and the Companies Act 2006 applicable to companies reporting under IFRS. The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities (including derivative instruments) at fair value through profit and loss. The consolidated financial statements have been prepared on a going concern basis.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are disclosed in Note 3.

There were no new standards, amendments and interpretations that were adopted by the Group and effective for the first time for the financial year beginning 1 April 2014 that were material to the Group.

A number of new standards, amendments and interpretations are effective for annual periods beginning after 1 April 2015 and have not yet been applied in preparing these financial statements. None of these are expected to have a significant effect or material impact on the financial statements of the Group.

The Directors are considering the impact of other standards and interpretations such as IFRS 15 and are assessing whether these will have a significant impact on the Group's financial results.

Basis of consolidation

Subsidiaries are entities controlled by the Company. Control exists when the Company is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The consolidated financial statements include the financial statements of the Company and its undertakings made up to 31 March 2015. The results of new subsidiary undertakings are included from the dates of acquisition using the purchase method of consolidation. Where a company has ceased to be a subsidiary undertaking during the year, its results are included to the date of cessation.

On acquisition, the assets, liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired (i.e. discount on acquisition) is credited to the income statement in the period of acquisition.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. All intra-Group transactions, balances, income and expenses are eliminated on consolidation.

Associates are entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The Group's share of its associates' profits or losses is recognised in the income statement. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment.

Partnerships are controlled when the Group has the power, directly or indirectly, to govern the financial and operating policies of the partnership so as to obtain benefits from its activities. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The consolidated financial statements include the financial statements of the KCOM Central Asset Reserve Limited Partnership and its undertakings made up to 31 March 2015. The results of new partnership undertakings are included from the dates of acquisition using the purchase method of consolidation. Where a company has ceased to be a partnership undertaking during the year, its results are included to the date of cessation.

Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker (CODM). The CODM, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the KCOM Group PLC Board of Directors. As described in Note 4, the Board assessed that the Kcom, Smart421 and Eclipse brands are aggregated together and reported as the 'Kcom' segment. The remaining brands of KC and the PLC function are reported respectively in the 'KC' segment and the 'PLC' segment.

Notes to the financial statements continued

for the year ended 31 March 2015

02 Accounting policies continued

Revenue recognition

Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods supplied, stated net of discounts, returns and value-added taxes. The Group recognises revenue when the amount of revenue can be reliably measured when it is probable that future economic benefits will flow to the entity and when specific criteria have been met for each of the Group's activities, as described below. The Group bases its estimate of return on historical results, taking into consideration the type of customer, the type of transaction and the specifics of each arrangement.

Revenue from calls is recognised in the Consolidated income statement at the time the call is made over the Group's network. Revenue from rentals is recognised evenly over the rental period.

Revenue from product sales is recognised at the point of effective transfer of risk and reward. Revenue from production of directories is recognised at the point when the directory is published. For large long-term annuity and multiple element customer contracts the Group is able to distinguish between the installation and the in-life service phases of a contract. Revenue is allocated based on the fair value of the consideration, which represents the market value of such services, or amounts per contracts, and will be recognised on the following basis for each phase:

- installation – within this phase revenue relating to resources and services is accounted for on a stage of completion basis where revenue is recognised with reference to the proportion of total costs incurred to date. Revenue related to equipment is accounted for based on the point of effective transfer of risks and rewards (shipment); and
- in-life service – revenue for this phase is recognised in line with the obligation to provide service as dictated by customer contracts.

Pre-contract costs, such as bid costs, on key contract wins are expensed as and when incurred.

Revenue arising from the provision of other services, including maintenance contracts, is recognised in the accounting period in which services are rendered, by reference to stage of completion of the specific transaction, and assessed on the basis of the actual service provided as a proportion of the total services to be provided.

Exceptional items

Exceptional items are disclosed separately in the financial statements where it is necessary to do so to provide better understanding of the financial performance of the Group. They are material items of income or expense that have been shown separately due to the significance of their nature or amount. In particular costs associated with organisational restructuring, costs and provisions associated with onerous contracts, profits or losses on the sale of an operation and one-off pension costs and credits are treated as exceptional items.

Intangible assets

Goodwill

Goodwill represents amounts arising on acquisition of subsidiary undertakings and is the difference between the cost of the acquisition and the fair value of the net identifiable assets at the date of acquisition.

Goodwill is stated at cost less any accumulated impairment losses and is tested annually or more frequently if events or changes in circumstances indicate potential impairment. Impairment losses on goodwill are not reversed.

Goodwill is allocated to cash-generating units (CGUs) for the purpose of impairment testing. The allocation is made to those CGUs that are expected to benefit from the business combination in which the goodwill arose. Each unit or group of units to which the goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal management purposes.

Development costs

An internally generated intangible asset arising from the Group's internal development activities is recognised only if all of the following conditions are met:

- an asset is created that can be identified (such as new processes);
- it is probable that the asset created will generate future economic benefits; and
- the development cost of the asset can be measured reliably.

Internally generated intangible assets are carried at cost less accumulated amortisation and are amortised on a straight-line basis over their useful lives. Where no internally generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred. Research costs are expensed to the income statement as and when they are incurred.

Customer and supplier relationships

Contractual customer and supplier relationships acquired in a business combination are recognised at fair value at the acquisition date. The contractual customer and supplier relations have a finite useful life and are carried at cost less accumulated amortisation. Amortisation is calculated using the straight-line method over the expected life of the relationship. These intangible assets are amortised on a straight-line basis over their useful lives.

Notes to the financial statements continued

for the year ended 31 March 2015

02 Accounting policies continued

Intangible assets continued

Technology and brand

Technology and brand acquired through business combinations are recorded at fair value at the date of acquisition. Assumptions are used in estimating the fair values of acquired intangible assets and include management's estimates of revenue and profits to be generated by the acquired businesses. These intangible assets are amortised on a straight-line basis over their useful lives.

Software

Software comprises computer software purchased from third parties and also the cost of internally developed software. Computer software purchased from third parties and internally developed software is initially recorded at cost.

Software development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the Group are recognised as intangible assets when the criteria detailed opposite is met. These intangible assets are amortised on a straight-line basis over their useful lives.

Other software development expenditures that do not meet these criteria are recognised as an expense as incurred. Software development costs previously recognised as an expense are not recognised as an asset in a subsequent period.

Amortisation

Amortisation of intangible assets is charged to the income statement on a straight-line basis over the estimated useful lives of each intangible asset. Intangible assets are amortised from the date they are available for use.

The estimated useful lives are as follows:

Customer and supplier relationships	up to 8 years
Technology and brand	up to 10 years
Software	up to 10 years
Development costs	3 years

Property, plant and equipment

Property, plant and equipment is stated at historical cost less accumulated depreciation and any provision for impairment. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Network infrastructure and related equipment (included within exchange equipment and external plant) is recorded at cost including labour costs directly attributable to the cost of the network construction. Depreciation is provided so as to write off the cost of assets to residual values on a straight-line basis over the assets' useful estimated lives as follows:

Freehold buildings	40 years
Leasehold buildings and improvements	period of lease
Exchange equipment	10 years
External plant	10 to 20 years
Vehicles, other apparatus and equipment	3 to 10 years

Freehold land is not depreciated.

Exchange equipment includes assets and equipment which relate to the network. External plant relates to assets which connect the network to our customers.

The residual value, if not insignificant, is reassessed annually. Depreciation of network infrastructure and related equipment is provided for from the date the network comes into operation.

Assets held under finance leases are depreciated over their expected useful lives on the same basis as owned assets or, where shorter, over the term of the relevant lease.

Fixed asset investments

Fixed asset investments are shown at cost less provision for impairment. They are reviewed at each reporting date for possible reversal of the impairment.

Impairment of non-financial assets

Assets that have an indefinite useful life – for example, goodwill – are not subject to amortisation and are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Recoverable amount is the higher of fair value less selling costs and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

An impairment loss is recognised whenever the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units (CGUs) are allocated first to reduce the carrying amount of any goodwill allocated to CGUs and then to reduce the carrying amount of other assets in the unit on a pro-rata basis.

Notes to the financial statements continued

for the year ended 31 March 2015

02 Accounting policies continued

Inventories

Inventories are stated at the lower of cost or net realisable value. Cost is determined using the weighted average cost method. Costs include raw materials and, where appropriate, direct overhead expenses. Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution. Provision is made for obsolete, slow moving or defective items where appropriate.

Trade receivables

Trade receivables are recognised initially at fair value and measured subsequently at amortised cost, using the effective interest method, less any impairment. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. The amount of provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the income statement within operating expenses. When a trade receivable is uncollectible, it is written off against the allowance account for trade receivables. Subsequent recoveries of amounts written off are credited against operating expenses in the income statement.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, short-term deposits and other short-term, highly liquid investments with original maturities of three months or less and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities on the balance sheet, unless a right of offset exists.

Trade payables

Trade payables are recognised initially at fair value and measured subsequently at amortised cost using the effective interest method.

Share capital

Ordinary shares are classified as equity.

Taxation

The tax expense represents the sum of the current tax and deferred tax expense.

The current tax is based on taxable profit for the year. Taxable profit differs from profit before tax as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and/or items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit and is accounted for using the balance sheet liability method. Deferred tax liabilities are recognised generally for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced or increased to the extent that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, and interests in joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited in the income statement, except when it relates to items recognised in other comprehensive income or directly to equity. In this case the deferred tax is also recognised in other comprehensive income or directly in equity, respectively.

Financial instruments and hedge accounting

Financial assets and liabilities are recognised in the Group's balance sheet when the Group becomes a party to the contractual provisions of the instrument.

The Group uses derivative financial instruments to hedge its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its Treasury policy, the Group does not hold or issue derivative financial instruments for trading purposes.

Derivative financial instruments are initially and subsequently recognised at fair value. Any gain or loss on remeasurement to fair value is recognised immediately in the income statement. However, where derivatives qualify for hedge accounting, recognition of the resultant gain or loss depends on the nature of the item being hedged.

The fair value of the interest rate swaps is the estimated amount that the Group would receive or pay to terminate the swap at the balance sheet date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The fair value of forward exchange contracts is their quoted market price at the balance sheet date, being the present value of the quoted forward price.

Notes to the financial statements continued

for the year ended 31 March 2015

02 Accounting policies continued

Financial instruments and hedge accounting continued

Changes in the fair value of derivative financial instruments that are designated and effective as hedges of future cash flows are recognised directly in other comprehensive income and the ineffective portion is recognised immediately in the income statement. If the cash flow hedge of a firm commitment or forecasted transaction results in the recognition of an asset or liability, then, at the time the asset or liability is recognised, the associated gains or losses on the derivative that had previously been recognised in other comprehensive income are included in the initial measurement of the asset or liability. For hedges that do not result in recognition of an asset or a liability, amounts deferred in equity are recognised in the income statement in the same period in which the hedged item affects net profit or loss.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised or no longer qualifies for hedge accounting. At that time, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement in the period.

Foreign currency translation

These financial statements are presented in Pounds Sterling which is the currency of the primary economic environment in which the Group operates.

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date.

Leasing and hire purchase commitments

Leases where the Group assumes substantially all of the risks and rewards of ownership are classified as finance leases. Assets held under finance leases and hire purchase contracts are capitalised in the balance sheet at their fair value or, if lower, the present value of the future minimum lease payments and are depreciated over their useful economic lives. The capital elements of future obligations under finance leases and hire purchase contracts are included as liabilities in the balance sheet. The interest elements of the rental obligations are charged to the income statement over the periods of the leases and hire purchase contracts. The finance charge is allocated to each period during the lease so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Rentals payable under operating leases are charged to the income statement on a straight-line basis over the lease term.

Bank borrowings and issue costs

Bank borrowings are stated at the amount of proceeds after deduction of issue costs, which are amortised over the period of the loan. Finance charges, including direct issue costs are accounted for in the income statement on an accruals basis and are added to the carrying amount of the instrument to the extent that they are not settled in the period in which they arise.

Borrowings are carried subsequently at amortised cost and any differences between the proceeds (net of transaction costs) and the redemption value are recognised in the income statement over the period of the borrowings using the effective interest method.

Pensions

Defined contribution

Obligations for contributions to the defined contribution (money purchase) scheme are charged to the income statement in the period they fall due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

Defined benefit

For defined benefit retirement schemes, the cost of providing benefits is determined using a building block approach, with actuarial valuations being carried out at each balance sheet date. Remeasurements are recognised in full in the period in which they occur and are recognised in equity and presented in the Consolidated statement of comprehensive income.

The current and past service costs of the scheme (the increase in the present value of employees' future benefits attributable to the current or prior periods) are charged to the income statement in the period. The cost or benefit of committed settlements and curtailments is recognised immediately in the income statement. The interest cost of the scheme is recognised in the income statement in the period to which it relates.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets. Any asset resulting from this calculation is limited to past service cost, plus the present value of available refunds and reductions in future contributions to the plan.

Employee share schemes and share-based payments

The Group has applied the requirements of IFRS 2. In accordance with the transitional provisions, IFRS 2 has been applied to all grants of equity instruments after 7 November 2002 that were unvested as of 1 April 2005.

The Group issues equity-settled share-based payments to certain employees.

Equity-settled employee schemes, including employee share options and discretionary long-term incentive schemes, provide employees with the option to acquire shares of the Company. Employee share options and long-term incentive schemes are generally subject to performance or service conditions.

Notes to the financial statements continued

for the year ended 31 March 2015

02 Accounting policies continued

Employee share schemes and share-based payments continued

The fair value of equity-settled share-based payments is measured at the date of grant and charged to the income statement over the period during which performance or service conditions are required to be met, or immediately where no performance or service criteria exist. The fair value of equity-settled share-based payments granted is measured using either the Black-Scholes or Monte Carlo model, depending on the terms under which the options were granted. The amount recognised as an expense is adjusted to reflect the actual number of employee share options that vest, except where forfeiture is only due to market-based performance criteria not being met.

At the end of each reporting period, the Group revises its estimates of the number of options that are expected to vest based on the non-market vesting conditions. It recognises the impact of the revision to original estimates, if any, in the income statement, with a corresponding adjustment to equity.

The Group also operates a Share Incentive Plan (SIP) under which employees have the option to purchase shares in the Company each month and offers employees free matching and partnership shares on a sliding scale of between 1:3 to 2:1. The Group recognises the free shares as an expense over the period of any applicable service condition, or immediately when no service condition exists.

Dividends

Dividend distribution to the Company's shareholders is recognised as a liability in the Group's financial statements in the period in which the dividends are approved by the Company's shareholders or, in the case of interim dividends, paid.

Dividend income is recognised when the right to receive payment is established.

Provisions

A provision is recognised in the balance sheet when the Group has a present, legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.