Independent auditors' report

to the members of KCOM Group PLC

Report on the financial statements

Our opinion

In our opinion:

- KCOM Group PLC's group financial statements and parent company financial statements (the "financial statements") give a true and fair view of the state of the group's and of the parent company's affairs as at 31 March 2015 and of the group's profit and the group's and the parent company's cash flows for the year then ended;
- the group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

What we have audited

KCOM Group PLC's financial statements comprise:

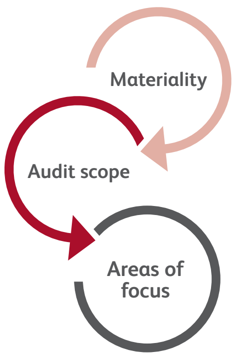
- the consolidated and parent company balance sheets as at 31 March 2015;
- the consolidated income statement and consolidated statement of comprehensive income for the year then ended;
- the consolidated and parent company cash flow statements for the year then ended;
- the consolidated and parent company statement of changes in shareholders' equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is applicable law and IFRSs as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Certain disclosures required by the financial reporting framework have been presented elsewhere in the Annual Report and accounts (the 'Annual Report'), rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited.

Our audit approach

Overview



Materiality

- Overall group materiality: £2.5 million which represents 5% of profit before tax and the impairment of goodwill.

Audit Scope

- The group engagement team performed audits of the complete financial information of all trading entities.

Areas of focus

- Valuation of goodwill.
- Valuation of defined benefit pension scheme liabilities.
- Capitalisation of internal project costs.
- Classification of costs as exceptional.

The scope of our audit and our areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)").

We designed our audit by determining materiality and assessing the risks of material misstatement in the financial statements. In particular, we looked at where the Directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the Directors that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as "areas of focus" in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Report on the financial statements continued

Our audit approach continued

The scope of our audit and our areas of focus continued

Area of focus	How our audit addressed the area of focus
Valuation of goodwill We focused on this area because the determination of whether or not goodwill is impaired involves complex and subjective judgements by management about the future results of the relevant parts of the business. On an annual basis, management calculate the amount of headroom between the value in use of the group's Cash Generating Units ('CGUs') and their carrying value to determine whether there is a potential impairment of the goodwill relating to those CGUs. The determination of the amount of headroom is dependent on the value in use of the CGU, which in turn, is dependent on estimates of short-term and long-term profit growth from operational improvements. Opening goodwill of £85.3m was split between 3 CGUs, Eclipse (£7.9m), Kcom (£72.3m) and Smart421 (£5.1m). We focused our audit efforts initially equally across the three CGUs before directing our attention to the Kcom CGU where management's assessment of value in use indicated an impairment of £33.9m to the £72.3m of goodwill. As a result of the impairment, headroom is reduced to zero. Any further changes in assumption may give rise to a potential further impairment. In testing management's assessment of the value in use in each of the CGUs we focused on the following key assumptions: - Budgeted cash flows for the next 5 years - The long term (terminal) growth rate applied beyond the end of the 5 year budget period - The discount rate applied to the model We also focused our audit attention on the sensitivity analysis and alternative scenarios prepared by management and assessed the likelihood of these scenarios occurring. See the accounting policies section within the financial statements for disclosure of the related accounting policies, judgements and estimates and Note 14 for detailed goodwill disclosures.	We evaluated the appropriateness of the key assumptions including discount rates and long-term growth rates and performed a range of sensitivity analyses across all CGUs. In particular: - We evaluated the reasonableness of management's forecasts by challenging assumed revenue growth strategies and planned operational improvements attributable to the ongoing transformation of the group based on growth and savings achieved in prior years; - We compared the terminal growth rates in the forecasts to third party economic and industry forecasts noting that those used by the Directors were within an acceptable range; - We assessed the discount rate (weighted average cost of capital ("WACC")) for the company against comparable organisations noting that the balances used across the group by the Directors were within a reasonable range; and - We evaluated management's sensitivity analysis and performed additional sensitivity analysis to ascertain the extent of change in those assumptions that either individually or collectively would be required for the goodwill to be impaired noting that in both Eclipse and Smart421 it would require a significantly adverse change to occur, and set of circumstances that we consider remote, before the balances would be impaired. In the Kcom CGU the 5 year forecasts are based on the 2016 budget prepared by Kcom and approved by the Board of KCOM Group PLC. We challenged management's budgeted growth rates over the 5 year period, evaluating the accuracy of management's forecasting process by comparing previous budgets to actual results, and assessing the current budget in light of our knowledge and understanding of current business plans and the economic climate. The long-term growth rate is based on a country specific terminal growth rate. We assessed this long term growth rate by reference to growth rates produced by third parties and determined that the planned level of profit growth both in the short and long term is achievable based on the previous performance of the business. Based on the evidence obtained we determined that the impairment booked in the Kcom CGU and the assessment that no impairment is required in either the Smart421 or Eclipse CGU were reasonable.

Independent auditors' report continued

to the members of KCOM Group PLC

Report on the financial statements continued

Our audit approach continued

The scope of our audit and our areas of focus continued

<table>
<tr><th>Area of focus</th><th>How our audit addressed the area of focus</th></tr>
<tr><td>Valuation of defined benefit pension scheme liabilities
We focused on this area as the pension scheme valuation is highly sensitive to changes in the assumptions used within the model which calculates the valuation and the subsequent charge or credit to the consolidated statement of comprehensive income ("OCI"). At 31 March 2015 the net pension deficit amounted to £31.4m.

The key assumptions to which the liability is most sensitive, and which we therefore paid particular attention to in evaluating the valuation of the net deficit, were:
• Discount rate: Under International Accounting Standard ("IAS") 19 – Employee Benefits, the discount rate is set with reference to the yield on high quality corporate bonds of term appropriate to the duration of the liabilities;
• Inflation rate: the level of future pension payments is linked to price inflation indices. Various investment market statistics are used to form a view on the long term average rates of retail price and consumer price inflation; and
• Mortality: Scheme specific base tables should be used with an allowance for future improvements in life expectancy based on recent projections. These projections will depend on future expectations of improvements in life expectancy and are therefore uncertain.

See the accounting policies section within the financial statements for disclosure of the related accounting policies, judgements and estimates and Note 29 for detailed pension disclosures.</td><td>We tested the actuarial valuations used by management in the preparation of the financial statements, as follows.

We tested the completeness and accuracy of the pension scheme membership data provided to management's actuary on which the pension liability is calculated by reconciling movements in membership data to supporting documentation. We noted no material exceptions from our testing.

We assessed the appropriateness and consistency of the methodology used by management including the key assumptions used to value the pension liabilities:
• Discount rate: We considered the appropriateness of the 3.25% discount rate assumption used by reference to the yields available on AA corporate bond indices and the duration of the Scheme's liabilities.
• Inflation rate: We considered the appropriateness of both the CPI and RPI rates used by reference to the Bank of England implied inflation spot curve and the duration of the Scheme's liabilities.
• Mortality: We considered the appropriateness of the base tables selected for use by management by reference to those provisionally adopted for the most recent actuarial valuation of the Scheme and also market practice.

Based on the evidence obtained from our testing of the assumptions outlined above, we considered the assumptions used to be in line with recognised market practices.</td></tr>
<tr><td>Capitalisation of internal project costs
We focused on this area because the group has been investing significantly in its back office systems and core IT applications. In the year this has resulted in the capitalisation of £2.3 million of internal salary costs in relation to this project. There is a degree of judgement involved in determining the element of internal salaries that may be considered to be directly attributable to this project and as such should be capitalised in line with the provisions of IAS 38 (Intangible Assets).

There is also judgement involved in assessing the recoverability of the carrying value of the asset created from the project given the difficulty in forecasting and measuring the financial benefits of the project over its forecast life.

See the accounting policies section within the financial statements for disclosure of the related accounting policies, judgements and estimates.</td><td>We tested capitalised salary costs to supporting payroll records to agree the existence of individuals and hours charged, and evaluated the nature of the costs to determine whether these costs were appropriately capitalised.

In evaluating the recoverability of the carrying value of the capitalised asset, the Directors prepared a model to evaluate the forecast benefit of the asset over its 10 year life.

We evaluated the Directors' model by testing costs capitalised to date - agreeing these to our work performed on capitalised internal salary costs and to third party advisor costs and by testing the benefits received to date to reductions in staff and IT costs. We challenged the forward looking spend and benefit assumptions in the model by examining the original business case, challenging the Directors on their commitment to the project and on how benefits would be derived in future years based upon the current business model. We also challenged the discount rate applied and the life of the project to check these were appropriate.

We did not identify any indication of incorrectly capitalised internal costs or indicators of impairment of the carrying value of the asset.</td></tr>
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Report on the financial statements continued

Our audit approach continued

The scope of our audit and our areas of focus continued

Area of focus	How our audit addressed the area of focus
Classification of costs as exceptional Exceptional items consist of a number of one off costs relating to the impairment of goodwill (£33.9m), restructuring and redundancy costs (£7.5m) as well as one off credits relating to claims (£5.3m) and other items (£1.4m). Given the magnitude of these items we focused additional audit effort in this area to determine whether these items were appropriately classified as exceptional, and did not in fact relate to the underlying trade of the business, and that exceptional costs and credits were treated consistently with prior periods. See the accounting policies section within the financial statements for disclosure of the related accounting policies, judgements and estimates and Note 7 for detailed exceptional costs disclosures.	We tested exceptional costs across all trading entities by evaluating their treatment for compliance with the group accounting policy, noting that the policy had been applied consistently for all items across the group. We tested the underlying transactions by agreeing redundancy costs to payments made and tested outstanding redundancy costs to payroll records and notification to the employees; by agreeing third party costs to third party invoices and by testing outstanding third party provisions to commitments and post year end payments. We tested exceptional credits to the corresponding cash receipts. Through these procedures we checked that these items had been recognised within the correct period. Our work in relation to the goodwill impairment is described in the area of focus above.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the group, the accounting processes and controls, and the industry in which the group operates.

The group is structured along two business segments, being KC and Kcom. Within these segments are five individual trading subsidiary entities (the ‘trading entities’). Together with the group’s centralised PLC function, these trading entities form the consolidated financial statements.

We performed an audit of the complete financial information of each of the trading entities, together with the group’s centralised PLC function, including the consolidation. All work was performed by the group engagement team. This work, including the consolidation, gave us the evidence we needed for our opinion on the group financial statements as a whole.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Overall group materiality	£2.5 million (2014: £2.5 million).
How we determined it	5% of profit before tax and the impairment of goodwill.
Rationale for benchmark applied	We believed that profit before tax, adjusted for the goodwill impairment charge provided us with an appropriate basis for determining materiality by eliminating the non-recurring disproportionate impact of this item. This is a change from the benchmark used in 2014, where profit before tax was considered the most appropriate benchmark only by virtue of the fact that no impairment charge was recorded in 2014. We also believed that this measure reflects the fact that shareholders measure the performance of the group on a pre-exceptional basis.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.1 million (2014: £0.1 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Going concern

Under the Listing Rules we are required to review the Directors’ statement, set out in the corporate governance section, in relation to going concern. We have nothing to report having performed our review.

As noted in the Directors’ statement, the Directors have concluded that it is appropriate to prepare the financial statements using the going concern basis of accounting. The going concern basis presumes that the group and parent company have adequate resources to remain in operation, and that the Directors intend them to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the Directors’ use of the going concern basis is appropriate.

However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the group’s and parent company’s ability to continue as a going concern.

Independent auditors' report continued

to the members of KCOM Group PLC

Other required reporting

Consistency of other information

Companies Act 2006 opinion

In our opinion, the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

ISAs (UK & Ireland) reporting

Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

Information in the Annual Report is: • materially inconsistent with the information in the audited financial statements; or • apparently materially incorrect based on, or materially inconsistent with, our knowledge of the group and parent company acquired in the course of performing our audit; or • otherwise misleading.	We have no exceptions to report arising from this responsibility.
the statement given by the Directors in the corporate governance section, in accordance with provision C.1.1 of the UK Corporate Governance Code ("the Code"), that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the group's and parent company's performance, business model and strategy is materially inconsistent with our knowledge of the group and parent company acquired in the course of performing our audit.	We have no exceptions to report arising from this responsibility.
the corporate governance section of the Annual Report, as required by provision C.3.8 of the Code, describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.	We have no exceptions to report arising from this responsibility.

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Directors' remuneration report – Companies Act 2006 opinion

In our opinion, the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

Other Companies Act 2006 reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of Directors' remuneration specified by law are not made. We have no exceptions to report arising from these responsibilities.

Corporate governance statement

Under the Listing Rules we are required to review the part of the Corporate Governance Statement relating to the parent company's compliance with ten provisions of the UK Corporate Governance Code. We have nothing to report having performed our review.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the Directors

As explained more fully in the Directors' Responsibilities Statement set out in the corporate governance section, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

What an audit of financial statements involves

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the group's and the parent company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the Directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the Directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Ian Morrison (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Leeds
17 June 2015