

Independent Auditors' Report to the Members of THUS Group plc

We have audited the Accounts on pages 28 to 44. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditors

The Directors are responsible for preparing the Annual Report and the Directors' Remuneration Report. As described on page 20, this includes responsibility for preparing the Accounts in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority, and by our profession's ethical guidance.

We report to you our opinion as to whether the Accounts give a true and fair view and whether the Accounts and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the Accounts, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions with the Group is not disclosed.

We review whether the Corporate Governance Statement on pages 18 to 20 reflects the Company's compliance with the nine provisions of the 2003 FRC Code specified for our review by the Listing Rules, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report, including the Corporate Governance Statement and the unaudited part of the Directors' Remuneration Report, and consider whether it is consistent with the audited Accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Accounts.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Accounts and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Accounts, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Accounts and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Accounts and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- the Accounts give a true and fair view of the state of affairs of the Company and the Group as at 31 March 2005 and of the loss of the Group for the year then ended; and
- the Accounts and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
8 Salisbury Square
London
EC4Y 8BB
20 May 2005

Notes

- (a) The maintenance and integrity of the THUS Group plc website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the Accounts or audit report since they were initially presented on the website.
- (b) Legislation in the United Kingdom governing the preparation and dissemination of Accounts may differ from legislation in other jurisdictions.

Accounting Policies and Definitions

Turnover definitions

The Group's turnover comprises revenues from data and telecom services, managed solutions services, Internet services, contact centre services and interactive services, each of which are defined as follows:

Data and telecom services

Revenues are derived from communication solutions, including the provision of switched services, capacity services, and data services.

Managed solutions services

Managed solutions services comprise revenues from the provision of voice telephony, data and Internet services as part of a bespoke contractual arrangement and are managed by a dedicated group set up for this purpose.

Internet services

Revenues from Internet services comprise monthly access fees paid by Internet dial up subscribers, ingress receipts, revenue from business access services (including the provision of leased lines, web design and e-commerce services) and revenues from wholesale Internet services.

Contact centre services

Revenues represent the provision of outsourced contact centres and related telemarketing, systems integration and consulting services activities.

Interactive services

Revenue from interactive services comprise the Group's share of premium rate call charges.

Cost definitions

The Group's costs comprise cost of sales, selling and distribution and administration costs.

Cost of sales

Cost of sales consists of interconnect costs and payments to other Public Telecommunications Operators (PTO's), network costs, network depreciation, contact centre costs, interactive royalties and related costs.

Selling and distribution costs

Selling and distribution costs comprise expenditure on marketing, advertising and promotions, together with the salaries and associated costs of the sales and marketing function.

Administration expenses

Administration expenses comprise expenditure on customer services, human resources, information technology, legal and regulatory compliance, finance department costs and non-operational property together with depreciation of non-network assets.

Other definitions

Company (or THUS)

THUS Group plc

ScottishTelecom Businesses

The businesses acquired by the Company on 30 September 1999 together with Scotland On-Line Limited.

Group

THUS Group plc and its subsidiaries and, for the periods prior to 30 September 1999, the ScottishTelecom businesses.

Subsidiary undertakings

Entities in which the Company holds a long-term controlling interest.

ScottishPower

Scottish Power plc and its subsidiaries.

Accounting Policies

A summary of the more important Group Accounting Policies is set out below:

The following principal accounting policies have been applied consistently, except as explained in Note 1 to the Accounts, in dealing with items which are considered material in relation to the Group's Accounts.

Basis of preparation

The Accounts have been prepared under the historical cost convention and in accordance with applicable accounting standards in the UK, subject to the true and fair override as noted below, and with the requirements of the Companies Act 1985.

Basis of consolidation

The Group Accounts include the Accounts of the Company and its subsidiary undertakings made up to 31 March 2005. Unless otherwise stated, the acquisition method of accounting has been adopted. Under this method, the results of subsidiary undertakings acquired or disposed of in the year are included in the consolidated Group Profit and Loss Account from the date of acquisition or up to the date of disposal. As noted below, the restructuring of the THUS Group was accounted for using the principles of merger accounting set out in Financial Reporting Standard 6 "Acquisitions and Mergers" (FRS 6) and Schedule 4A to the Companies Act 1985.

The final step of the restructuring of the THUS Group was the redesignation (on 19 March 2002) of the THUS Group plc Preference Shares to ordinary shares, the relative rights of shareholders at the start and end of the restructuring process did not remain unchanged. As a result, the restructuring did not meet the definition of a group reconstruction under FRS 6 which would have required the restructuring to be accounted for under acquisition accounting principles. This would have resulted in all the separate assets and liabilities of THUS plc being recorded at fair value, goodwill or negative goodwill and goodwill amortisation charges or credits arising and only the post acquisition results of THUS plc being reported in the consolidated Profit and Loss Account. The Directors of the Company did not believe that this would have given a true and fair view of the state of affairs of the Group and of its results as, in substance, the change in the relative rights of the shareholders was incidental to the main purpose of the restructuring which was a change in the identity of the holding company rather than an acquisition of a business.

Consequently, the restructuring was accounted for using merger accounting principles as the Directors of the Company considered this was necessary in order to meet the overriding requirement of the Companies Act 1985 to show a true and fair view. The Directors of the Company consider that it is not practicable to quantify the effect of this departure from the detailed accounting requirements without incurring significant and disproportionate cost.

The market capitalisation of THUS plc on 12 March 2002 adjusted for preference shares was approximately £210m. On 15 March 2002, and after a share issue of £275m, which was substantially applied to debt repayment the market capitalisation of THUS plc, adjusted for preference shares was approximately £285m.

The adjusted market capitalisation of THUS plc would potentially indicate a fair value of consideration of a similar amount, compared to net assets acquired at their book value of approximately £475m (post share issue and debt repayment).

In order to quantify the difference between merger accounting applied and acquisition accounting, fair values would have to have been computed for both the consideration and all acquired assets. Sector issues current in March 2002, including a major UK based competitor breaching its banking covenants and delisting from the London Stock Exchange and also a number of international telecommunications companies with presence in the UK experiencing significant business difficulties made it difficult to determine realistic or meaningful fair values from market values. As a result of these sector issues, the market value of THUS plc suffered significant fluctuations, and asset values were difficult to assess, as a relevant price between a willing buyer and a willing seller could not be easily ascertained.

Under Section 230 (4) of the Companies Act 1985 the Company is exempt from the requirement to present its own Profit and Loss Account.

Turnover

Turnover represents the value of goods and services supplied to customers during the year (net of Value Added Tax).

The Group earns revenue from the transmission of content on its network originated by third party providers. The Group assesses whether revenue should be recorded gross as principal or net as agent, based on the features of such arrangements including the following indicators:

- whether the Group holds itself out as agent
- establishment of the price
- provision of customer remedies
- performance of part of the service
- assumption of credit risk

Revenues from sales of telecommunication equipment are recognised upon delivery to the customer. Connection revenues are recognised upon connection of the customer to the network. Costs of connecting a customer to a network are also charged to the Profit and Loss Account at the point when the customer connects to the network.

All other revenue is recognised as earned.

Indefeasible Rights of Use (“IRU”) sales

As part of its service offering, the Group periodically sells dark fibre to other network operators seeking to extend their own networks under IRU agreements. These agreements extend for all of the assets’ expected useful lives and transfer substantially all of the risks and benefits of ownership to the buyer. In a number of cases, the Group has acquired dark fibre under IRU agreements from the same counterparties in order to complete its own network.

Where the consideration received by the Group for such IRU sales is in cash and there is no separate agreement with the buyer to acquire fibre, the resulting profit/(loss) is shown in the Accounts as a gain/(loss) on the disposal of fixed assets.

Where the sale of fibre for cash has occurred and there is a separate agreement with the buyer, involving the Group acquiring fibre of a similar value at a similar time, the Directors have concluded that it is most appropriate to record the sale and purchase transactions at fair value with the gain arising on the sale treated as unrealised and recorded in the Statement of Total Recognised Gains and Losses.

Unrealised gains and losses are recognised over the life of the agreement.

Interest

All interest payable and receivable is reflected in the Profit and Loss Account as it accrues.

Debt issue costs are accounted for as an adjustment to the amount of debt outstanding and are included within finance charges over the life of the associated borrowings. Debt issue costs relating to surplus loan facilities are written off immediately on identification of that surplus.

Tax

The charge for tax is based on the results for the period and takes into account full provision for deferred tax, using the approach set out in Financial Reporting Standard 19 “Deferred Tax” (FRS 19) in respect of timing differences on a non-discounted basis. A recoverability test is applied to deferred tax assets.

Intangible fixed assets

Licence fees are capitalised at cost, less provision for any impairment in value, and amortised over the remaining licence period once the relevant network to which a licence relates becomes operational and a service is launched to the public.

Costs associated with the development of new products or services are capitalised and amortised over the anticipated life of the new product or service once this is launched to the public.

Investments

Investments in subsidiary undertakings are stated in the Balance Sheet of the Parent Company at cost less provision for any permanent diminution in value.

Own shares held under trust

Own shares held represent shares in the Company purchased for employee share options and are presented in the Balance Sheet as a deduction from equity. No gain or loss is recognised in the Profit and Loss Account on the sale, issuance or cancellation in connection with these shares.

The impact of this accounting policy change is detailed in Note 1 to the Accounts.

Tangible fixed assets

Tangible fixed assets are stated at cost, less provision for any impairment in value, and are depreciated using the straight line method over their estimated operational lives. Tangible fixed assets include capitalised employee costs and other costs which are directly attributable to the construction of fixed assets. The main depreciation periods used are as set out below:

Land and leasehold buildings	Years
Alterations to leasehold premises	Over lease period or useful life if shorter
Buildings: Equipment accommodation modules	10
Plant and equipment	
Underground network	40
Fibre optic cable	20
Electronics, customers’ systems and base stations	10
Customer connections	5
Tools	4
Other	
Furniture and fittings	10
Vehicles	4
Computers and related software	3 to 5

Stocks

Stocks are valued at the lower of cost and net realisable value.

Finance and operating leases

Assets leased by the Group under finance leases are capitalised and depreciated in line with the Group’s depreciation policy. The interest element of the finance lease repayments is charged to the Profit and Loss Account in proportion to the balance of the capital repayments outstanding. Rentals payable under operating leases are charged to the Profit and Loss Account on a straight line basis. Rent free periods received by the Group, at the inception of new operating leases for properties, are recognised in the Profit and Loss Account over the period of the lease or, if shorter than the full lease term, over the period to the renewal date at which the rent is first expected to be adjusted to the prevailing market rate.

Foreign currencies

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. At the year end, monetary assets and liabilities denominated in foreign currencies are translated at the rate of exchange ruling at the Balance Sheet date. Any gain or loss arising on the restatement of such balances is taken to the Profit and Loss Account. The Accounts of the overseas entity and branch are translated at the rate of exchange ruling at the Balance Sheet date. The exchange difference arising on the retranslation of opening net assets is taken directly to reserves.

Financial instruments

Charges relating to financial instruments acquired to reduce risk to interest rate exposure are charged to the Profit and Loss Account as incurred.

Pensions

Pension costs for the defined benefit pension scheme are accounted for on the basis of charging the expected cost of providing pensions over the period during which the Group benefits from the employees’ services. The effects of variations from regular costs are spread over the expected remaining working lifetime of the members of the scheme after making suitable allowances for future withdrawals. Contributions to defined contribution pension plans are charged to the Profit and Loss Account in the period in which they are incurred. The pension cost figures used in these Accounts comply with the current pension cost accounting standard, Statement of Standard Accounting Practice 24 “Accounting for Pension Costs” (SSAP 24).

Financial Reporting Standard 17 “Retirement Benefits” (FRS 17) was issued on 30 November 2000. Under the transitional arrangements permitted by FRS 17, the Group is required to disclose the information in Note 26.

For a minority of employees the Group pays varying levels of contributions to personal pension schemes. The costs are charged against the Profit and Loss Account as incurred.

Group Profit and Loss Account

for the year ended 31 March 2005

	Notes	2005 Continuing operations before exceptional item £'000	2005 Exceptional item £'000	2005 Continuing operations £'000	2005 Discontinued operations £'000	2005 Total £'000
Turnover	2	340,605	-	340,605	19,411	360,016
Cost of sales	5, 7	(287,448)	(8,126)	(295,574)	(16,650)	(312,224)
Gross profit		53,157	(8,126)	45,031	2,761	47,792
Selling and distribution		(22,045)	-	(22,045)	(803)	(22,848)
Administration expenses	7	(56,701)	-	(56,701)	(5,957)	(62,658)
Other operating income	3	1,415	-	1,415	-	1,415
Operating loss	3	(24,174)	(8,126)	(32,300)	(3,999)	(36,299)
Loss on sale of fixed assets – continuing operations		-	-	-	-	-
Loss on sale of discontinued businesses		-	-	-	(314)	(314)
Loss on ordinary activities before interest and other similar charges		(24,174)	(8,126)	(32,300)	(4,313)	(36,613)
Net interest payable and other similar charges	8					(4,862)
Loss on ordinary activities before tax						(41,475)
Tax on loss on ordinary activities	9					(741)
Loss for the financial year	22					(42,216)
Loss and diluted loss per ordinary share (pence)	10					(3.17)

The comparative year is shown below.

Group Profit and Loss Account

for the year ended 31 March 2004

	Notes	2004 Continuing operations (Restated) £'000	2004 Discontinued operations (Restated) £'000	2004 Total (Restated) £'000
Turnover	2	297,711	34,661	332,372
Cost of sales	7	(238,251)	(24,594)	(262,845)
Gross profit		59,460	10,067	69,527
Selling and distribution		(24,215)	(1,702)	(25,917)
Administration expenses	7	(58,729)	(6,383)	(65,112)
Other operating income	3	289	-	289
Operating loss	3	(23,195)	1,982	(21,213)
Loss on sale of fixed assets – continuing operations		(266)	-	(266)
Loss on sale of discontinued businesses		-	-	-
Loss on ordinary activities before interest and other similar charges		(23,461)	1,982	(21,479)
Net interest payable and other similar charges	8			(5,270)
Loss on ordinary activities before tax				(26,749)
Tax on loss on ordinary activities	9			(212)
Loss for the financial year				(26,961)
Loss and diluted loss per ordinary share (pence)	10			(2.03)

There were no acquisitions in either the current or previous year.

The Accounting Policies and Definitions on pages 28 and 29, together with the Notes on pages 34 to 44 form part of the Accounts.

Consolidated Statement of Total Recognised Gains and Losses

for the year ended 31 March 2005

	Notes 1	2005 £'000	2004 (Restated) £'000
Loss for the financial year		(42,216)	(26,961)
Currency translation differences on overseas net assets	22	36	(38)
Unrealised gains on fixed asset disposals		-	839
Total recognised gains and losses relating to the year		(42,180)	(26,160)
Prior year adjustment for UITF 38	1	16,645	
Total recognised gains and losses recognised since the last annual report		(25,535)	

Reconciliation of Movements in Shareholders' Funds

for the year ended 31 March 2005

	Notes 1	2005 £'000	2004 (Restated) £'000
Loss for the financial year		(42,216)	(26,961)
Currency translation differences on overseas net assets	22	36	(38)
Unrealised gains on fixed asset disposals		-	839
Receipts from exercise of share options	22	26	22
Share option charge	22	588	365
Net movement in shareholders' funds		(41,566)	(25,773)
Opening shareholders' funds at beginning of year as previously stated		382,992	407,412
Prior year adjustment for UITF 38	1	(3,019)	(1,666)
Shareholders' funds at beginning of year as restated		379,973	405,746
Closing shareholders' funds		338,407	379,973

The Accounting Policies and Definitions on pages 28 and 29, together with the Notes on pages 34 to 44 form part of the Accounts.

Balance Sheets

as at 31 March 2005

	Notes	Group		Company	
		2005 £'000	2004 (Restated) £'000	2005 £'000	2004 £'000
Fixed assets					
Intangible assets	11	247	136	-	-
Tangible assets	12	372,923	412,796	-	-
Investments	13	-	-	56,963	56,963
		373,170	412,932	56,963	56,963
Current assets					
Stocks	14	3,101	3,125	-	-
Debtors:					
Amounts falling due within one year	15	74,436	93,498	-	-
Amounts falling due after more than one year	15	2,400	3,471	-	-
		76,836	96,969	-	-
Cash at bank and in hand	25	28,548	26,421	87	87
Total current assets		108,485	126,515	87	87
Creditors: amounts falling due within one year					
Loans and other borrowings	17	(11,549)	(1,583)	-	-
Other creditors	16	(84,924)	(99,973)	(627)	(627)
Total creditors falling due within one year		(96,473)	(101,556)	(627)	(627)
Net current assets/(liabilities)		12,012	24,959	(540)	(540)
Total assets less current liabilities		385,182	437,891	56,423	56,423
Creditors: amounts falling due after more than one year					
Loans and other borrowings	17	(45,980)	(57,179)	-	-
Total creditors falling due after more than one year		(45,980)	(57,179)	-	-
Provisions for liabilities and charges	19	(795)	(739)	-	-
Net assets		338,407	379,973	56,423	56,423
Capital and reserves					
Called-up share capital	21	33,715	33,715	33,715	33,715
Merger reserve	22	566,560	566,560	-	-
Capital redemption reserve	22	23,248	23,248	23,248	23,248
Other reserves	22	17,713	18,700	-	-
Profit and loss account	22	(302,829)	(262,250)	(540)	(540)
Equity shareholders' funds		338,407	379,973	56,423	56,423

The Accounting Policies and Definitions on pages 28 and 29, together with the Notes on pages 34 to 44 form part of the Accounts.

Approved by the Board on 20 May 2005 and signed on its behalf by

William Allan
Chief Executive

John Maguire
Chief Financial Officer

Group Cash Flow Statement

for the year ended 31 March 2005

	Notes	2005 £'000	2004 (Restated) £'000
Net cash inflow from operating activities	24	45,677	37,418
Returns on investments and servicing of finance	23a	(3,379)	(3,351)
Tax		(1,002)	–
Free cash flow*		41,296	34,067
Capital expenditure	23b	(37,547)	(36,686)
Cash inflow/(outflow) before disposals		3,749	(2,619)
Disposals	23c	(11)	–
Cash inflow/(outflow) before financing		3,738	(2,619)
Financing	23d	(1,619)	16,897
Increase in cash in the year	25	2,119	14,278

* Free cash flow represents cash flow from operating activities after adjusting for returns on investments and servicing of finance and tax.

Reconciliation of Net Cash Flow to Movement in Net Debt

for the year ended 31 March 2005

	Notes	2005 £'000	2004 £'000
Increase in cash in the year	25	2,119	14,278
Cash outflow/(inflow) from reduction/(increase) in debt	23d, 25	1,645	(16,875)
Change in net debt resulting from cash flows	25	3,764	(2,597)
Other non-cash movements	25	600	(100)
Movement in net debt in the year		4,364	(2,697)
Net debt at the beginning of the year	25	(35,354)	(32,657)
Net debt at the end of the year	25	(30,990)	(35,354)

The Accounting Policies and Definitions on pages 28 and 29, together with the Notes on pages 34 to 44 form part of the Accounts.