

REINSURANCE GROUP OF AMERICA INC  
Form 10-Q  
November 06, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

x

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2012

OR

..

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 1-11848

**REINSURANCE GROUP OF AMERICA, INCORPORATED**

(Exact name of Registrant as specified in its charter)

**MISSOURI**  
(State or other jurisdiction)

**43-1627032**  
(IRS employer

of incorporation or organization)

identification number)

1370 Timberlake Manor Parkway

Chesterfield, Missouri 63017

(Address of principal executive offices)

(636) 736-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of October 31, 2012, 73,853,716 shares of the registrant's common stock were outstanding.

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**REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES**

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**Table of Contents****REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

	September 30, 2012	December 31, 2011
	(Dollars in thousands, except share data)	
<b>Assets</b>		
Fixed maturity securities:		
Available-for-sale at fair value (amortized cost of \$18,905,283 and \$14,182,880 at September 30, 2012 and December 31, 2011, respectively)	\$ 21,658,414	\$ 16,200,950
Mortgage loans on real estate (net of allowances of \$13,333 and \$11,793 at September 30, 2012 and December 31, 2011, respectively)	2,256,881	991,731
Policy loans	1,243,498	1,260,400
Funds withheld at interest	5,608,640	5,410,424
Short-term investments	90,789	88,566
Other invested assets	1,236,616	1,012,541
<b>Total investments</b>	<b>32,094,838</b>	<b>24,964,612</b>
Cash and cash equivalents	1,603,730	962,870
Accrued investment income	250,048	144,334
Premiums receivable and other reinsurance balances	1,179,687	1,059,572
Reinsurance ceded receivables	623,954	626,194
Deferred policy acquisition costs	3,630,877	3,543,925
Other assets	540,879	332,466
<b>Total assets</b>	<b>\$ 39,924,013</b>	<b>\$ 31,633,973</b>
<b>Liabilities and Stockholders Equity</b>		
Future policy benefits	\$ 11,093,483	\$ 9,903,886
Interest-sensitive contract liabilities	13,254,859	8,394,468
Other policy claims and benefits	3,132,526	2,841,373
Other reinsurance balances	218,057	118,219
Deferred income taxes	1,806,186	1,679,834
Other liabilities	1,217,788	810,775
Long-term debt	1,815,111	1,414,688
Collateral finance facility	651,968	652,032
<b>Total liabilities</b>	<b>33,189,978</b>	<b>25,815,275</b>
<b>Commitments and contingent liabilities (See Note 8)</b>		
<b>Stockholders Equity:</b>		
Preferred stock (par value \$.01 per share; 10,000,000 shares authorized; no shares issued or outstanding)	--	--
Common stock (par value \$.01 per share; 140,000,000 shares authorized; shares issued: 79,137,758 at September 30, 2012 and December 31, 2011)	791	791
Additional paid-in-capital	1,743,822	1,727,774
Retained earnings	3,154,317	2,818,429
Treasury stock, at cost; 5,285,409 and 5,770,024 shares at September 30, 2012 and December 31, 2011, respectively	(316,542)	(346,449)
Accumulated other comprehensive income	2,151,647	1,618,153
<b>Total stockholders equity</b>	<b>6,734,035</b>	<b>5,818,698</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 39,924,013</b>	<b>\$ 31,633,973</b>

See accompanying notes to condensed consolidated financial statements (unaudited).



**Table of Contents****REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
(Dollars in thousands, except per share data)				
<b>Revenues:</b>				
Net premiums	\$ 1,912,746	\$ 1,776,165	\$ 5,726,889	\$ 5,300,971
Investment income, net of related expenses	396,781	268,210	1,066,055	976,686
Investment related gains (losses), net:				
Other-than-temporary impairments on fixed maturity securities	(1,996)	(11,911)	(11,562)	(19,049)
Other-than-temporary impairments on fixed maturity securities transferred to (from) accumulated other comprehensive income	(559)	3,089	(7,618)	3,381
Other investment related gains (losses), net	78,608	(130,778)	162,554	27,076
Total investment related gains (losses), net	76,053	(139,600)	143,374	11,408
Other revenues	63,501	90,132	181,491	192,254
Total revenues	2,449,081	1,994,907	7,117,809	6,481,319
<b>Benefits and Expenses:</b>				
Claims and other policy benefits	1,662,625	1,514,765	4,868,220	4,504,227
Interest credited	130,341	35,251	285,080	237,510
Policy acquisition costs and other insurance expenses	318,106	164,372	961,679	785,138
Other operating expenses	103,786	94,029	319,425	297,340
Interest expense	29,749	27,025	76,431	77,412
Collateral finance facility expense	2,995	3,069	8,840	9,372
Total benefits and expenses	2,247,602	1,838,511	6,519,675	5,910,999
<b>Income before income taxes</b>	201,479	156,396	598,134	570,320
Provision for income taxes	57,004	21,794	189,230	162,854
<b>Net income</b>	\$ 144,475	\$ 134,602	\$ 408,904	\$ 407,466
<b>Earnings per share:</b>				
Basic earnings per share	\$ 1.96	\$ 1.82	\$ 5.55	\$ 5.53
Diluted earnings per share	\$ 1.95	\$ 1.81	\$ 5.52	\$ 5.49
<b>Dividends declared per share</b>	\$ 0.24	\$ 0.18	\$ 0.60	\$ 0.42

See accompanying notes to condensed consolidated financial statements (unaudited).

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**REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands)

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
<b>Comprehensive income:</b>				
Net income	\$ 144,475	\$ 134,602	\$ 408,904	\$ 407,466
<b>Other comprehensive income, net of income tax:</b>				
Change in foreign currency translation adjustments	36,248	(101,842)	43,463	(65,948)
Change in net unrealized gain on investments	315,501	354,709	483,242	470,473
Change in other-than-temporary impairment losses on fixed maturity securities	364	(2,008)	4,952	(2,198)
Changes in pension and other postretirement plan adjustments	336	708	1,837	1,280
Total other comprehensive income	352,449	251,567	533,494	403,607
<b>Total comprehensive income, net of income tax</b>	<b>\$ 496,924</b>	<b>\$ 386,169</b>	<b>\$ 942,398</b>	<b>\$ 811,073</b>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	Nine months ended September 30,	
	2012	2011
	(Dollars in thousands)	
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 408,904	\$ 407,466
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in operating assets and liabilities:		
Accrued investment income	(60,684)	(64,464)
Premiums receivable and other reinsurance balances	(102,447)	(86,339)
Deferred policy acquisition costs	(70,107)	(60,792)
Reinsurance ceded receivable balances	2,240	42,409
Future policy benefits, other policy claims and benefits, and other reinsurance balances	1,406,844	669,174
Deferred income taxes	(99,200)	58,207
Other assets and other liabilities, net	225,749	(46,320)
Amortization of net investment premiums, discounts and other	(61,644)	(100,328)
Investment related gains, net	(143,374)	(11,408)
Gain on repurchase of collateral finance facility securities	--	(55,840)
Excess tax benefits from share-based payment arrangement	262	(4,418)
Other, net	22,533	86,630
Net cash provided by operating activities	1,529,076	833,977
<b>Cash Flows from Investing Activities:</b>		
Sales of fixed maturity securities available-for-sale	3,970,569	2,338,405
Maturities of fixed maturity securities available-for-sale	122,405	195,582
Purchases of fixed maturity securities available-for-sale	(4,660,131)	(3,104,714)
Cash invested in mortgage loans	(350,823)	(117,697)
Cash invested in policy loans	(8,032)	(8,928)
Cash invested in funds withheld at interest	(81,602)	(23,784)
Principal payments on mortgage loans on real estate	85,921	60,764
Principal payments on policy loans	24,934	8,456
Change in short-term investments and other invested assets	(129,874)	(86,895)
Net cash used in investing activities	(1,026,633)	(738,811)
<b>Cash Flows from Financing Activities:</b>		
Dividends to stockholders	(44,220)	(31,039)
Repurchase of collateral finance facility securities	--	(111,831)
Proceeds from long-term debt issuance	400,000	397,788
Debt issuance costs	(6,255)	(3,400)
Proceeds from redemption and remarketing of trust preferred securities	--	154,588
Maturity of trust preferred securities	--	(159,473)
Purchases of treasury stock	(6,924)	(380,345)
Excess tax benefits from share-based payment arrangement	(262)	4,418
Exercise of stock options, net	4,096	8,680
Change in cash collateral for derivative positions	(62,896)	163,250
Deposits on universal life and other investment type policies and contracts	89,458	328,903
Withdrawals on universal life and other investment type policies and contracts	(249,190)	(119,180)
Net cash provided by financing activities	123,807	252,359
Effect of exchange rate changes on cash	14,610	(8,535)
Change in cash and cash equivalents	640,860	338,990



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Cash and cash equivalents, beginning of period	962,870	463,661
Cash and cash equivalents, end of period	\$ 1,603,730	\$ 802,651

### Supplementary information:

Cash paid for interest	\$ 76,514	\$ 57,821
Cash paid for income taxes, net of refunds	\$ 81,391	\$ 110,075

Non-cash supplementary information - See Note 4 - Investments

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of Contents**REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements****(Unaudited)****1. Organization and Basis of Presentation**

Reinsurance Group of America, Incorporated ( RGA ) is an insurance holding company that was formed on December 31, 1992. The accompanying unaudited condensed consolidated financial statements of RGA and its subsidiaries (collectively, the Company ) have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. There were no subsequent events that would require disclosure or adjustments to the accompanying condensed consolidated financial statements through the date the financial statements were issued. These unaudited condensed consolidated financial statements include the accounts of RGA and its subsidiaries, all intercompany accounts and transactions have been eliminated. The December 31, 2011 consolidated balance sheet data was derived from the Company's 2011 Annual Report on Form 10-K ( 2011 Annual Report ) filed with the Securities and Exchange Commission ( SEC ) on February 29, 2012 and the revised 2011 consolidated financial statements and notes thereto included in the Company's 2012 Current Report on Form 8-K ( DAC Current Report ) filed with the SEC on July 13, 2012. Therefore, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Company included in the DAC Current Report.

In October 2010, the Financial Accounting Standards Board ( FASB ) amended the general accounting principles for *Financial Services Insurance* as it relates to accounting for costs associated with acquiring or renewing insurance contracts. This amendment clarified that only those costs that result directly from and are essential to the contract transaction and that would not have been incurred had the contract transaction not occurred can be capitalized. It also defined acquisitions costs as costs that are related directly to the successful acquisition of new or renewal insurance contracts.

The Company filed the DAC Current Report in response to its adoption of the amendment described above on January 1, 2012 on a retrospective basis. The DAC Current Report reflects the impact of the adoption of this amendment on the Company's previously filed financial statements and other disclosures included in the 2011 Annual Report, including that (i) only costs related directly to the successful acquisition of new or renewal contracts can be capitalized as deferred acquisition costs and (ii) all other acquisition-related costs must be expensed as incurred. In connection therewith, the Company adjusted the presentation of certain prior-period information to conform to the new accounting principle. The Company believes retrospective adoption provides the most comparable and useful financial information for financial statement users. Likewise, the financial statements and notes thereto presented in this Quarterly Report on Form 10-Q have been adjusted to reflect the retrospective adoption of this accounting principle.

The following tables present the effects of the retrospective adoption of the new accounting principle on the Company's previously reported condensed consolidated statement of income and condensed consolidated statement of cash flows for the three and nine months ended September 30, 2011 (in thousands, except share amounts):

	As Reported	Three months ended September 30, 2011 Adjustments	As Amended
<b>Benefits and Expenses:</b>			
Policy acquisition costs and other insurance expenses	\$ 149,228	\$ 15,144	\$ 164,372
Income before income taxes	171,540	(15,144)	156,396
Provision for income taxes	24,155	(2,361)	21,794
Net income	\$ 147,385	\$ (12,783)	\$ 134,602

**Earnings per share:**

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Basic earnings per share	\$	2.00	\$	(0.18)	\$	1.82
Diluted earnings per share	\$	1.98	\$	(0.17)	\$	1.81

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	As Reported	Nine months ended September 30, 2011 Adjustments	As Amended
<b>Benefits and Expenses:</b>			
Policy acquisition costs and other insurance expenses	\$ 741,663	\$ 43,475	\$ 785,138
Income before income taxes	613,795	(43,475)	570,320
Provision for income taxes	172,706	(9,852)	162,854
Net income	\$ 441,089	\$ (33,623)	\$ 407,466

**Earnings per share:**

Basic earnings per share	\$ 5.99	\$ (0.46)	\$ 5.53
Diluted earnings per share	\$ 5.94	\$ (0.45)	\$ 5.49

	As Reported	Nine months ended September 30, 2011 Adjustments	As Amended
<b>Cash Flows from Operating Activities:</b>			
Net Income	\$ 441,089	\$ (33,623)	\$ 407,466
Change in operating assets and liabilities			
Deferred policy acquisition costs	(104,267)	43,475	(60,792)
Deferred income taxes	68,059	(9,852)	58,207

**2. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share on net income (in thousands, except per share information):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
<b>Earnings:</b>				
Net income (numerator for basic and diluted calculations)	\$ 144,475	\$ 134,602	\$ 408,904	\$ 407,466
<b>Shares:</b>				
Weighted average outstanding shares (denominator for basic calculation)	73,776	73,856	73,690	73,680
Equivalent shares from outstanding stock options <sup>(1)</sup>	362	398	388	527
Denominator for diluted calculation	74,138	74,254	74,078	74,207
<b>Earnings per share:</b>				
Basic	\$ 1.96	\$ 1.82	\$ 5.55	\$ 5.53
Diluted	\$ 1.95	\$ 1.81	\$ 5.52	\$ 5.49

(1) Year-to-date amounts are the weighted average of the individual quarterly amounts.

The calculation of common equivalent shares does not include the impact of options having a strike or conversion price that exceeds the average stock price for the earnings period, as the result would be antidilutive. The calculation of common equivalent shares also excludes the impact of outstanding performance contingent shares, as the conditions necessary for their issuance have not been satisfied as of the end of the reporting period. For the three months ended September 30, 2012, approximately 0.7 million stock options and approximately 0.7 million performance contingent shares were excluded from the calculation. For the three months ended September 30, 2011, approximately 1.1 million stock options and approximately 0.8 million performance contingent shares were excluded from the calculation.

**Table of Contents****3. Accumulated Other Comprehensive Income**

The balance of and changes in each component of accumulated other comprehensive income ( AOCI ) for the nine months ended September 30, 2012 and 2011 are as follows (dollars in thousands):

	Accumulated Other Comprehensive Income (Loss), Net of Income Tax			
	Accumulated Currency Translation Adjustments	Unrealized Appreciation of Securities	Pension and Postretirement Benefits	Total
Balance, December 31, 2011	\$ 229,795	\$ 1,419,318	\$ (30,960)	\$ 1,618,153
Change in component during the period	43,463	488,194	1,837	533,494
Balance, September 30, 2012	\$ 273,258	\$ 1,907,512	\$ (29,123)	\$ 2,151,647

	Accumulated Other Comprehensive Income (Loss), Net of Income Tax			
	Accumulated Currency Translation Adjustments	Unrealized Appreciation of Securities	Pension and Postretirement Benefits	Total
Balance, December 31, 2010	\$ 255,295	\$ 651,449	\$ (14,560)	\$ 892,184
Change in component during the period	(65,948)	468,275	1,280	403,607
Balance, September 30, 2011	\$ 189,347	\$ 1,119,724	\$ (13,280)	\$ 1,295,791

**4. Investments**

All investments held by the Company are monitored for conformance to the qualitative and quantitative limits prescribed by the applicable jurisdiction's insurance laws and regulations. In addition, the operating companies' boards of directors periodically review their respective investment portfolios. The Company's investment strategy is to maintain a predominantly investment-grade, fixed maturity securities portfolio, which will provide adequate liquidity for expected reinsurance obligations and maximize total return through prudent asset management. The Company's asset/liability duration matching differs between operating companies. Based on Canadian reserve requirements, the Canadian liabilities are matched with long-duration Canadian assets. The duration of the Canadian portfolio exceeds twenty years, however, the average duration for all portfolios, when consolidated, ranges between eight and ten years.

*Investment Income, Net of Related Expenses*

Major categories of investment income, net of related expenses consist of the following (dollars in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Fixed maturity securities available-for-sale	\$ 221,212	\$ 190,990	\$ 633,110	\$ 566,581
Mortgage loans on real estate	26,938	14,474	67,258	41,801
Policy loans	16,519	16,454	49,637	49,549
Funds withheld at interest	127,855	41,267	305,861	306,028
Short-term investments	960	393	3,027	2,201
Other invested assets	13,117	11,470	35,803	31,680
Investment revenue	406,601	275,048	1,094,696	997,840
Investment expense	(9,820)	(6,838)	(28,641)	(21,154)

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Investment income, net of related expenses	\$ 396,781	\$ 268,210	\$ 1,066,055	\$ 976,686
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**Table of Contents***Investment Related Gains (Losses), Net*

Investment related gains (losses), net, consist of the following (dollars in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Fixed maturity and equity securities available for sale:				
Other-than-temporary impairment losses on fixed maturities	\$ (1,996)	\$ (11,911)	\$ (11,562)	\$ (19,049)
Portion of loss recognized in accumulated other comprehensive income (before taxes)	(559)	3,089	(7,618)	3,381
Net other-than-temporary impairment losses on fixed maturities recognized in earnings	(2,555)	(8,822)	(19,180)	(15,668)
Impairment losses on equity securities	--	--	(3,025)	(3,680)
Gain on investment activity	53,173	34,840	102,078	92,423
Loss on investment activity	(6,668)	(7,182)	(23,090)	(20,749)
Other impairment losses and change in mortgage loan provision	(10,301)	(2,370)	(14,382)	(4,980)
Derivatives and other, net	42,404	(156,066)	100,973	(35,938)
Total investment related gains (losses), net	\$ 76,053	\$ (139,600)	\$ 143,374	\$ 11,408

The net other-than-temporary impairment losses on fixed maturity securities recognized in earnings of \$19.2 million and \$15.7 million in the first nine months of 2012 and 2011, respectively, are primarily due to a decline in value of structured securities with exposure to commercial mortgages and general credit deterioration in select corporate and foreign securities. The gain on investment activity increased primarily due to repositioning of securities for duration matching during the third quarter of 2012. The increase in other impairment losses was primarily due to \$7.5 million of impairments in the limited partnership asset class in the third quarter of 2012. The volatility in derivatives and other for the three and nine months ended September 30, 2012 is primarily due to changes in the fair value of embedded derivative liabilities associated with modified coinsurance and funds withheld treaties and guaranteed minimum benefit riders.

During the three months ended September 30, 2012 and 2011, the Company sold fixed maturity and equity securities with fair values of \$220.5 million and \$57.2 million at losses of \$6.7 million and \$7.2 million, respectively. During the nine months ended September 30, 2012 and 2011, the Company sold fixed maturity and equity securities with fair values of \$622.1 million and \$388.9 million at losses of \$23.1 million and \$20.7 million, respectively. The Company generally does not engage in short-term buying and selling of securities.

*Other-Than-Temporary Impairments*

As discussed in Note 2 Summary of Significant Accounting Policies of the DAC Current Report, a portion of certain other-than-temporary impairment ( OTTI ) losses on fixed maturity securities are recognized in AOCI. For these securities the net amount recognized in earnings ( credit loss impairments ) represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between the fair value and amortized cost is recognized in AOCI. The following table sets forth the amount of pre-tax credit loss impairments on fixed maturity securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in AOCI, and the corresponding changes in such amounts (dollars in thousands):

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	Three months ended September 30,	
	2012	2011
Balance, beginning of period	\$ 45,903	\$ 52,484
Initial impairments - credit loss OTTI recognized on securities not previously impaired	--	5,259
Additional impairments - credit loss OTTI recognized on securities previously impaired	1,306	2,432
Credit loss OTTI previously recognized on securities impaired to fair value during the period	(2,622)	--
Credit loss OTTI previously recognized on securities which matured, paid down, prepaid or were sold during the period	(20,725)	(752)
Balance, end of period	\$ 23,862	\$ 59,423

	Nine months ended September 30,	
	2012	2011
Balance, beginning of period	\$ 63,947	\$ 47,291
Initial impairments - credit loss OTTI recognized on securities not previously impaired	1,962	6,731
Additional impairments - credit loss OTTI recognized on securities previously impaired	10,187	6,871
Credit loss OTTI previously recognized on securities impaired to fair value during the period	(22,291)	--
Credit loss OTTI previously recognized on securities which matured, paid down, prepaid or were sold during the period	(29,943)	(1,470)
Balance, end of period	\$ 23,862	\$ 59,423

*Fixed Maturity and Equity Securities Available-for-Sale*

The following tables provide information relating to investments in fixed maturity and equity securities by sector as of September 30, 2012 and December 31, 2011 (dollars in thousands):

September 30, 2012:	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	% of Total	Other-than-
						temporary impairments in AOCI
<b>Available-for-sale:</b>						
Corporate securities	\$ 10,885,071	\$ 1,059,275	\$ 44,624	\$ 11,899,722	55.0 %	\$ --
Canadian and Canadian provincial governments	2,653,761	1,438,124	2	4,091,883	18.9	--
Residential mortgage-backed securities	980,655	80,614	5,461	1,055,808	4.9	(477)
Asset-backed securities	588,851	18,050	34,201	572,700	2.6	(2,295)
Commercial mortgage-backed securities	1,663,493	137,153	60,255	1,740,391	8.0	(6,111)
U.S. government and agencies	251,417	33,458	18	284,857	1.3	--
State and political subdivisions	254,845	38,784	6,212	287,417	1.3	--
Other foreign government, supranational and foreign government-sponsored enterprises	1,627,190	100,539	2,093	1,725,636	8.0	--
Total fixed maturity securities	\$ 18,905,283	\$ 2,905,997	\$ 152,866	\$ 21,658,414	100.0 %	\$ (8,883)
Non-redeemable preferred stock	\$ 69,182	\$ 6,332	\$ 834	\$ 74,680	35.7 %	
Other equity securities	133,037	1,555	-	134,592	64.3	
Total equity securities	\$ 202,219	\$ 7,887	\$ 834	\$ 209,272	100.0 %	



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<b>December 31, 2011:</b>	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	% of Total	Other-than- temporary impairments in AOCI
<b>Available-for-sale:</b>						
Corporate securities	\$ 6,931,958	\$ 654,519	\$ 125,371	\$ 7,461,106	46.0 %	\$ --
Canadian and Canadian provincial governments	2,507,802	1,362,160	29	3,869,933	23.9	--
Residential mortgage-backed securities	1,167,265	76,393	16,424	1,227,234	7.6	(1,042)
Asset-backed securities	443,974	11,692	53,675	401,991	2.5	(5,256)
Commercial mortgage-backed securities	1,233,958	87,750	79,489	1,242,219	7.7	(12,225)
U.S. government and agencies	341,087	32,976	61	374,002	2.3	--
State and political subdivisions	184,308	24,419	3,341	205,386	1.3	--
Other foreign government, supranational and foreign government-sponsored enterprises	1,372,528	50,127	3,576	1,419,079	8.7	--
<b>Total fixed maturity securities</b>	<b>\$ 14,182,880</b>	<b>\$ 2,300,036</b>	<b>\$ 281,966</b>	<b>\$ 16,200,950</b>	<b>100.0 %</b>	<b>\$ (18,523)</b>
Non-redeemable preferred stock	\$ 82,488	\$ 4,677	\$ 8,982	\$ 78,183	68.6 %	
Other equity securities	35,352	1,903	1,538	35,717	31.4	
<b>Total equity securities</b>	<b>\$ 117,840</b>	<b>\$ 6,580</b>	<b>\$ 10,520</b>	<b>\$ 113,900</b>	<b>100.0 %</b>	

The Company enters into various collateral arrangements that require both the pledging and acceptance of fixed maturity securities as collateral, which are excluded from the tables above. The Company pledged fixed maturity securities as collateral to derivative and reinsurance counterparties with an amortized cost of \$32.0 million and \$29.0 million, and an estimated fair value of \$37.2 million and \$32.6 million, as of September 30, 2012 and December 31, 2011 respectively, which are included in other invested assets in the condensed consolidated balance sheets.

The Company received fixed maturity securities as collateral from derivative and reinsurance counterparties with an estimated fair value of \$95.3 million and \$1.0 million, as of September 30, 2012 and December 31, 2011, respectively. The collateral is held in separate custodial accounts and is not recorded on the Company's condensed consolidated balance sheets. Subject to certain constraints, the Company is permitted by contract to sell or re-pledge this collateral; however, as of September 30, 2012 and December 31, 2011, none of the collateral had been sold or re-pledged.

The Company participates in a securities borrowing program whereby securities, which are not reflected on the Company's condensed consolidated balance sheets, are borrowed from a third party. The Company is required to maintain a minimum of 100% of the market value of the borrowed securities as collateral. The Company had borrowed securities with an amortized cost and an estimated fair value of \$237.5 million and \$150.0 million as of September 30, 2012 and December 31, 2011, respectively. The borrowed securities are used to provide collateral under an affiliated reinsurance transaction.

As of September 30, 2012, the Company held securities with a fair value of \$1,261.0 million that were issued by the Canadian province of Ontario and \$1,187.2 million that were issued by an entity that is guaranteed by the Canadian province of Quebec, both of which exceeded 10% of total stockholders' equity. As of December 31, 2011, the Company held securities with a fair value of \$1,171.2 million that were issued by the Canadian province of Ontario and \$1,107.7 million that were issued by an entity that is guaranteed by the Canadian province of Quebec, both of which exceeded 10% of total stockholders' equity.

The amortized cost and estimated fair value of fixed maturity securities available-for-sale at September 30, 2012 are shown by contractual maturity in the table below. Actual maturities can differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. At September 30, 2012, the contractual maturities of investments in fixed maturity securities were as follows (dollars in thousands):

Available-for-sale:	Amortized Cost	Fair Value

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Due in one year or less	\$	247,507	\$	251,672
Due after one year through five years		3,767,244		3,950,306
Due after five year through ten years		6,172,841		6,757,674
Due after ten years		5,484,692		7,329,863
Asset and mortgage-backed securities		3,232,999		3,368,899
Total	\$	18,905,283	\$	21,658,414

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The tables below show the major industry types of the Company's corporate fixed maturity holdings as of September 30, 2012 and December 31, 2011 (dollars in thousands):

<b>September 30, 2012:</b>		Estimated	
	Amortized Cost	Fair Value	% of Total
Finance	\$ 3,551,382	\$ 3,802,951	32.0 %
Industrial	5,583,541	6,146,069	51.6
Utility	1,715,512	1,914,809	16.1
Other	34,636	35,893	0.3
<b>Total</b>	<b>\$ 10,885,071</b>	<b>\$ 11,899,722</b>	<b>100.0 %</b>

<b>December 31, 2011:</b>		Estimated	
	Amortized Cost	Fair Value	% of Total
Finance	\$ 2,411,175	\$ 2,442,149	32.7 %
Industrial	3,402,099	3,760,187	50.4
Utility	1,115,384	1,255,090	16.9
Other	3,300	3,680	-
<b>Total</b>	<b>\$ 6,931,958</b>	<b>\$ 7,461,106</b>	<b>100.0 %</b>

The creditworthiness of Greece, Ireland, Italy, Portugal and Spain, commonly referred to as Europe's peripheral region, is under ongoing stress and uncertainty due to high debt levels and economic weakness. The Company did not have exposure to sovereign fixed maturity securities, which includes global government agencies, from Europe's peripheral region as of September 30, 2012 and December 31, 2011. In addition, the Company did not purchase or sell credit protection, through credit default swaps, referenced to sovereign entities of Europe's peripheral region. The tables below show the Company's exposure to sovereign fixed maturity securities originated in countries other than Europe's peripheral region, included in Other foreign government, supranational and foreign government-sponsored enterprises, as of September 30, 2012 and December 31, 2011 (dollars in thousands):

<b>September 30, 2012:</b>		Estimated	
	Amortized Cost	Fair Value	% of Total
Australia	\$ 454,131	\$ 470,628	33.3 %
Japan	221,977	228,478	16.2
United Kingdom	129,960	140,478	10.0
Cayman Islands	69,333	76,661	5.4
South Africa	63,037	67,240	4.8
New Zealand	54,077	54,716	3.9
Germany	42,360	45,229	3.2
South Korea	41,396	44,619	3.2
France	38,694	41,945	3.0
Other	215,586	240,896	17.0
<b>Total</b>	<b>\$ 1,330,551</b>	<b>\$ 1,410,890</b>	<b>100.0 %</b>

<b>December 31, 2011:</b>		Estimated	
	Amortized Cost	Fair Value	% of Total
Australia	\$ 437,713	\$ 446,694	39.1 %
Japan	214,994	219,276	19.2
United Kingdom	118,618	130,106	11.4

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Germany	72,926	75,741	6.6
New Zealand	51,547	51,544	4.5
South Africa	37,624	38,528	3.4
South Korea	30,592	32,025	2.8
Other	139,927	148,792	13.0
Total	\$ 1,103,941	\$ 1,142,706	100.0 %

The tables below show the Company's exposure to non-sovereign fixed maturity and equity securities, based on the security's country of issuance, from Europe's peripheral region as of September 30, 2012 and December 31, 2011 (dollars in thousands):

**Table of Contents****September 30, 2012:**

	Amortized Cost	Estimated Fair Value	% of Total
<b>Financial institutions:</b>			
Ireland	\$ 3,592	\$ 4,057	4.4 %
Spain	23,347	23,215	25.0
Total financial institutions	26,939	27,272	29.4
<b>Other:</b>			
Ireland	26,346	27,528	29.7
Italy	6,393	6,394	6.9
Spain	31,694	31,525	34.0
Total other	64,433	65,447	70.6
Total	\$ 91,372	\$ 92,719	100.0 %

**December 31, 2011:**

	Amortized Cost	Estimated Fair Value	% of Total
<b>Financial institutions:</b>			
Ireland	\$ 4,084	\$ 4,397	5.9 %
Spain	25,565	20,378	27.6
Total financial institutions	29,649	24,775	33.5
<b>Other:</b>			
Ireland	12,474	13,149	17.8
Italy	2,898	2,808	3.8
Spain	34,459	33,137	44.9
Total other	49,831	49,094	66.5
Total	\$ 79,480	\$ 73,869	100.0 %

*Unrealized Losses for Fixed Maturity and Equity Securities Available-for-Sale*

The following table presents the total gross unrealized losses for the 618 and 940 fixed maturity and equity securities as of September 30, 2012 and December 31, 2011, respectively, where the estimated fair value had declined and remained below amortized cost by the indicated amount (dollars in thousands):

	September 30, 2012		December 31, 2011	
	Gross Unrealized Losses	% of Total	Gross Unrealized Losses	% of Total
Less than 20%	\$ 55,930	36.4 %	\$ 131,155	44.8 %
20% or more for less than six months	509	0.3	51,503	17.6
20% or more for six months or greater	97,261	63.3	109,828	37.6
Total	\$ 153,700	100.0 %	\$ 292,486	100.0 %

As of September 30, 2012 and December 31, 2011, respectively, 52.8% and 65.3% of these gross unrealized losses were associated with investment grade securities. The unrealized losses on these securities decreased primarily due to a decline in interest rates since December 31,

2011.

The Company's determination of whether a decline in value is other-than-temporary includes analysis of the underlying credit and the extent and duration of a decline in value. The Company's credit analysis of an investment includes determining whether the issuer is current on its contractual payments, evaluating whether it is probable that the Company will be able to collect all amounts due according to the contractual terms of the security and analyzing the overall ability of the Company to recover the amortized cost of the investment. The Company continues to consider valuation declines as a potential indicator of credit deterioration. The Company believes that due to fluctuating market conditions and an extended period of economic uncertainty, the extent and duration of a decline in value have become less indicative of when there has been credit deterioration with respect to a fixed maturity security since it may not have an impact on the ability of the issuer to service all scheduled payments and the Company's evaluation of the recoverability of all contractual cash flows or the ability to recover an amount at least equal to amortized cost. In the Company's impairment review process, the duration and severity of an unrealized loss position for equity securities are given greater weight and consideration given the lack of contractual cash flows or deferability features.

The following tables present the estimated fair values and gross unrealized losses, including other-than-temporary impairment losses reported in AOCI, for 618 and 940 fixed maturity and equity securities that have estimated fair values below amortized cost as of September 30, 2012 and December 31, 2011, respectively (dollars in thousands). These investments are presented by class and grade of security, as well as the length of time the related market value has remained below amortized cost.

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<b>September 30, 2012:</b>	Less than 12 months		12 months or greater		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
<b>Investment grade securities:</b>						
Corporate securities	\$ 436,908	\$ 7,947	\$ 168,366	\$ 26,006	\$ 605,274	\$ 33,953
Canadian and Canadian provincial governments	589	2	--	--	589	2
<b>Residential mortgage-backed securities:</b>						
Asset-backed securities	21,365	113	21,236	4,763	42,601	4,876
Commercial mortgage-backed securities	55,260	1,286	101,691	20,960	156,951	22,246
U.S. government and agencies	117,736	1,350	40,110	9,546	157,846	10,896
State and political subdivisions	6,715	18	--	--	6,715	18
Other foreign government, supranational and foreign government-sponsored enterprises	2,885	1,272	18,409	4,940	21,294	6,212
	53,671	1,068	16,589	1,025	70,260	2,093
<b>Total investment grade securities</b>	<b>695,129</b>	<b>13,056</b>	<b>366,401</b>	<b>67,240</b>	<b>1,061,530</b>	<b>80,296</b>
<b>Non-investment grade securities:</b>						
Corporate securities	133,893	4,330	63,817	6,341	197,710	10,671
Residential mortgage-backed securities	7,774	55	4,304	530	12,078	585
Asset-backed securities	--	--	18,244	11,955	18,244	11,955
Commercial mortgage-backed securities	12,157	492	60,373	48,867	72,530	49,359
<b>Total non-investment grade securities</b>	<b>153,824</b>	<b>4,877</b>	<b>146,738</b>	<b>67,693</b>	<b>300,562</b>	<b>72,570</b>
<b>Total fixed maturity securities</b>	<b>\$ 848,953</b>	<b>\$ 17,933</b>	<b>\$ 513,139</b>	<b>\$ 134,933</b>	<b>\$ 1,362,092</b>	<b>\$ 152,866</b>
<b>Non-redeemable preferred stock</b>						
	\$ 734	\$ 6	\$ 6,744	\$ 828	\$ 7,478	\$ 834
<b>Total equity securities</b>	<b>\$ 734</b>	<b>\$ 6</b>	<b>\$ 6,744</b>	<b>\$ 828</b>	<b>\$ 7,478</b>	<b>\$ 834</b>
<b>December 31, 2011:</b>	Less than 12 months		12 months or greater		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
<b>Investment grade securities:</b>						
Corporate securities	\$ 790,758	\$ 40,180	\$ 286,244	\$ 63,117	\$ 1,077,002	\$ 103,297

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Canadian and Canadian provincial governments	3,094	29	--	--	3,094	29
Residential mortgage-backed securities	128,622	3,549	58,388	10,382	187,010	13,931
Asset-backed securities	101,263	3,592	93,910	29,036	195,173	32,628
Commercial mortgage-backed securities	109,455	3,538	58,979	22,001	168,434	25,539
U.S. government and agencies	1,764	61	--	--	1,764	61
State and political subdivisions	21,045	1,845	12,273	1,268	33,318	3,113
Other foreign government, supranational and foreign government-sponsored enterprises	148,416	1,085	16,588	2,491	165,004	3,576
<b>Total investment grade securities</b>	<b>1,304,417</b>	<b>53,879</b>	<b>526,382</b>	<b>128,295</b>	<b>1,830,799</b>	<b>182,174</b>
Non-investment grade securities:						
Corporate securities	212,795	10,852	47,310	11,222	260,105	22,074
Residential mortgage-backed securities	23,199	712	10,459	1,781	33,658	2,493
Asset-backed securities	2,363	940	21,275	20,107	23,638	21,047
Commercial mortgage-backed securities	34,918	7,220	62,357	46,730	97,275	53,950
State and political subdivisions	4,000	228	--	--	4,000	228
<b>Total non-investment grade securities</b>	<b>277,275</b>	<b>19,952</b>	<b>141,401</b>	<b>79,840</b>	<b>418,676</b>	<b>99,792</b>
<b>Total fixed maturity securities</b>	<b>\$ 1,581,692</b>	<b>\$ 73,831</b>	<b>\$ 667,783</b>	<b>\$ 208,135</b>	<b>\$ 2,249,475</b>	<b>\$ 281,966</b>
Non-redeemable preferred stock	\$ 19,516	\$ 4,478	\$ 15,694	\$ 4,504	\$ 35,210	\$ 8,982
Other equity securities	1,662	602	5,905	936	7,567	1,538
<b>Total equity securities</b>	<b>\$ 21,178</b>	<b>\$ 5,080</b>	<b>\$ 21,599</b>	<b>\$ 5,440</b>	<b>\$ 42,777</b>	<b>\$ 10,520</b>

As of September 30, 2012, the Company does not intend to sell these fixed maturity securities and does not believe it is more likely than not that it will be required to sell these fixed maturity securities before the recovery of the fair value up to the current amortized cost of the investment, which may be maturity. However, unforeseen facts and circumstances may cause the Company to sell fixed maturity securities in the ordinary course of managing its portfolio to meet certain diversification, credit quality, asset-liability management and liquidity guidelines.

As of September 30, 2012, the Company has the ability and intent to hold the equity securities until the recovery of the fair value up to the current cost of the investment. However, unforeseen facts and circumstances may cause the Company to sell



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equity securities in the ordinary course of managing its portfolio to meet certain diversification, credit quality and liquidity guidelines.

Unrealized losses on non-investment grade securities are principally related to asset-backed securities, residential mortgage-backed securities and commercial mortgage-backed securities and were the result of wider credit spreads resulting from higher risk premiums since the time of initial purchase, largely due to macroeconomic conditions and credit market deterioration, including the impact of lower real estate valuations. As of September 30, 2012 and December 31, 2011, approximately \$61.4 million and \$68.6 million, respectively, of gross unrealized losses greater than 12 months was associated with non-investment grade asset and mortgage-backed securities. This class of securities was evaluated based on actual and projected collateral losses relative to the securities' positions in the respective securitization trusts and security specific expectations of cash flows. This evaluation also takes into consideration credit enhancement, measured in terms of (i) subordination from other classes of securities in the trust that are contractually obligated to absorb losses before the class of security the Company owns, and (ii) the expected impact of other structural features embedded in the securitization trust beneficial to the class of securities the Company owns, such as overcollateralization and excess spread.

*Purchased Credit Impaired Fixed Maturity Securities Available-for-Sale*

In the third quarter of 2012, the Company began purchasing certain residential mortgage-backed securities that had experienced deterioration in credit quality since their issuance. Securities acquired with evidence of credit quality deterioration since origination and for which it is probable at the acquisition date that the Company will be unable to collect all contractually required payments are classified as purchased credit impaired securities. For each security, the excess of the cash flows expected to be collected as of the acquisition date over its acquisition date fair value is referred to as the accretable yield and is recognized as net investment income on an effective yield basis. At the date of acquisition, the timing and amount of the cash flows expected to be collected was determined based on a best estimate using key assumptions, such as interest rates, default rates and prepayment speeds. If subsequently, based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected to be collected, the accretable yield is adjusted prospectively. The excess of the contractually required payments (including interest) as of the acquisition date over the cash flows expected to be collected as of the acquisition date is referred to as the nonaccretable difference, and this amount is not expected to be realized as net investment income. Decreases in cash flows expected to be collected can result in OTTI.

The following tables present information on the Company's purchased credit impaired securities, which are included in fixed maturity securities available-for-sale (dollars in thousands):

	September 30, 2012	
Outstanding principal and interest balance <sup>(1)</sup>	\$	36,090
Carrying value, including accrued interest <sup>(2)</sup>	\$	31,196

(1) Represents the contractually required payments which is the sum of contractual principal, whether or not currently due, and accrued interest.

(2) Estimated fair value plus accrued interest.

The following table presents information about purchased credit impaired investments acquired during the nine months ended September 30, 2012 (dollars in thousands).

	At Date of Acquisition	
Contractually required payments (including interest)	\$	50,268
Cash flows expected to be collected <sup>(1)</sup>	\$	42,316
Fair value of investments acquired	\$	30,853

(1) Represents undiscounted principal and interest cash flow expectations at the date of acquisition.

The following table presents activity for the accretable yield on purchased credit impaired securities for the nine months ended September 30, 2012 (dollars in thousands):

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	Nine months ended September 30, 2012	
Balance, beginning of period	\$	--
Investments purchased		11,463
Accretion		(6)
Balance, end of period	\$	11,457

**Table of Contents***Mortgage Loans on Real Estate*

Mortgage loans represented approximately 6.7% and 3.8% of the Company's cash and invested assets as of September 30, 2012 and December 31, 2011, respectively. The Company makes mortgage loans on income producing properties, such as apartments, retail and office buildings, light warehouses and light industrial facilities. Loan-to-value ratios at the time of loan approval are 75% or less. The distribution of mortgage loans, gross of valuation allowances, by property type is as follows as of September 30, 2012 and December 31, 2011 (dollars in thousands):

Property type:	September 30, 2012		December 31, 2011	
	Recorded Investment	Percentage of Total	Recorded Investment	Percentage of Total
Apartment	\$ 238,365	10.5 %	\$ 124,674	12.4 %
Retail	618,896	27.3	335,745	33.5
Office building	803,889	35.4	264,584	26.4
Industrial	454,215	20.0	200,762	20.0
Other commercial	154,849	6.8	77,759	7.7
Total	\$ 2,270,214	100.0 %	\$ 1,003,524	100.0 %

As of September 30, 2012 and December 31, 2011, the Company's mortgage loans, gross of valuation allowances, were distributed throughout the United States as follows (dollars in thousands):

	September 30, 2012		December 31, 2011	
	Recorded Investment	Percentage of Total	Recorded Investment	Percentage of Total
Pacific	\$ 613,425	27.0 %	\$ 269,922	26.9 %
South Atlantic	470,722	20.7	233,534	23.3
Mountain	198,443	8.7	116,224	11.6
Middle Atlantic	311,192	13.7	86,590	8.6
West North Central	155,745	6.9	69,789	7.0
East North Central	221,085	9.7	92,861	9.2
West South Central	147,177	6.5	58,506	5.8
East South Central	60,121	2.7	40,767	4.1
New England	92,304	4.1	35,331	3.5
Total	\$ 2,270,214	100.0 %	\$ 1,003,524	100.0 %

The maturities of the mortgage loans, gross of valuation allowances, as of September 30, 2012 and December 31, 2011 are as follows (dollars in thousands):

	September 30, 2012	December 31, 2011
Due one year through five years	\$ 1,234,191	\$ 493,027
Due after five years	731,618	299,252
Due after ten years	304,405	211,245
Total	\$ 2,270,214	\$ 1,003,524

Information regarding the Company's credit quality indicators for its recorded investment in mortgage loans, gross of valuation allowances, as of September 30, 2012 and December 31, 2011 is as follows (dollars in thousands):

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Internal credit risk grade:	September 30, 2012	December 31, 2011
High investment grade	\$ 1,153,162	\$ 252,333
Investment grade	871,508	526,608
Average	134,205	105,177
Watch list	73,977	91,037
In or near default	37,362	28,369
Total	\$ 2,270,214	\$ 1,003,524

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The age analysis of the Company's past due recorded investment in mortgage loans, gross of valuation allowances, as of September 30, 2012 and December 31, 2011 is as follows (dollars in thousands):

	September 30, 2012	December 31, 2011
31-60 days past due	\$ 16,627	\$ 21,800
61-90 days past due	--	--
Greater than 90 days	16,298	20,316
Total past due	32,925	42,116
Current	2,237,289	961,408
Total	\$ 2,270,214	\$ 1,003,524

The following table presents the recorded investment in mortgage loans, by method of evaluation of credit loss, and the related valuation allowances, by type of credit loss, at (dollars in thousands):

	September 30, 2012	December 31, 2011
<b>Mortgage loans:</b>		
Evaluated individually for credit losses	\$ 44,394	\$ 60,904
Evaluated collectively for credit losses	2,225,820	942,620
Mortgage loans, gross of valuation allowances	2,270,214	1,003,524
<b>Valuation allowances:</b>		
Specific for credit losses	8,343	8,188
Non-specifically identified credit losses	4,990	3,605
Total valuation allowances	13,333	11,793
Mortgage loans, net of valuation allowances	\$ 2,256,881	\$ 991,731

Information regarding the Company's loan valuation allowances for mortgage loans for the three months ended September 30, 2012 and 2011 is as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Balance, beginning of period	\$ 11,011	\$ 7,692	\$ 11,793	\$ 6,239
Charge-offs	(526)	--	(4,595)	(1,157)
Provision	2,848	2,370	6,135	4,980
Balance, end of period	\$ 13,333	\$ 10,062	\$ 13,333	\$ 10,062

Information regarding the portion of the Company's mortgage loans that were impaired as of September 30, 2012 and December 31, 2011 is as follows (dollars in thousands):

Unpaid	Recorded	Related	Carrying Value
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	Principal Balance	Investment	Allowance	
<b>September 30, 2012:</b>				
Impaired mortgage loans with no valuation allowance recorded	\$ 13,127	\$ 12,585	\$ --	\$ 12,585
Impaired mortgage loans with valuation allowance recorded	31,939	31,809	8,343	23,466
Total impaired mortgage loans	\$ 45,066	\$ 44,394	\$ 8,343	\$ 36,051
<b>December 31, 2011:</b>				
Impaired mortgage loans with no valuation allowance recorded	\$ 32,088	\$ 31,496	\$ --	\$ 31,496
Impaired mortgage loans with valuation allowance recorded	29,724	29,408	8,188	21,220
Total impaired mortgage loans	\$ 61,812	\$ 60,904	\$ 8,188	\$ 52,716

The Company's average investment in impaired mortgage loans and the related interest income are reflected in the table below for the periods indicated (dollars in thousands):

	Three Months Ended			
	September 30, 2012		September 30, 2011	
	Average Investment <sup>(1)</sup>	Interest Income	Average Investment <sup>(1)</sup>	Interest Income
Impaired mortgage loans with no valuation allowance recorded	\$ 11,054	\$ 109	\$ 4,706	\$ 32
Impaired mortgage loans with valuation allowance recorded	35,047	461	31,351	202
Total	\$ 46,101	\$ 570	\$ 36,057	\$ 234

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	Nine Months Ended			
	September 30, 2012		September 30, 2011	
	Average Investment <sup>(1)</sup>	Interest Income	Average Investment <sup>(1)</sup>	Interest Income
Impaired mortgage loans with no valuation allowance recorded	\$ 16,312	\$ 305	\$ 11,228	\$ 102
Impaired mortgage loans with valuation allowance recorded	36,178	1,180	25,046	678
<b>Total</b>	<b>\$ 52,490</b>	<b>\$ 1,485</b>	<b>\$ 36,274</b>	<b>\$ 780</b>

(1) Average recorded investment represents the average loan balances as of the beginning of period and all subsequent quarterly end of period balances. The Company did not acquire any impaired mortgage loans during the nine months ended September 30, 2012 and 2011. The Company had \$16.3 million and \$20.3 million of mortgage loans, gross of valuation allowances, that were on nonaccrual status at September 30, 2012 and December 31, 2011, respectively.

*Other Invested Assets*

Other invested assets include equity securities, limited partnership interests, structured loans and derivative contracts. Other invested assets represented approximately 3.7% and 3.9% of the Company's cash and invested assets as of September 30, 2012 and December 31, 2011, respectively. Carrying values of these assets as of September 30, 2012 and December 31, 2011 are as follows (dollars in thousands):

	September 30, 2012	December 31, 2011
Equity securities	\$ 209,272	\$ 113,900
Limited partnerships and joint ventures	350,643	251,315
Structured loans	341,795	281,022
Derivatives	212,322	257,050
Other	122,584	109,254
<b>Total other invested assets</b>	<b>\$ 1,236,616</b>	<b>\$ 1,012,541</b>

*Investments Transferred to the Company*

During the second quarter of 2012, the Company added a large fixed deferred annuity reinsurance transaction in its U.S. Asset Intensive sub-segment. This transaction increased the Company's invested asset base by approximately \$5.4 billion which was reflected on the condensed consolidated balance sheet as of June 30, 2012 as an investment receivable. In satisfaction of this investment receivable, the Company received the following on July 31, 2012 and August 3, 2012 (dollars in thousands):

	Amortized Cost/ Recorded Investment	Estimated Fair Value
<b>Fixed maturity securities available for sale:</b>		
Corporate securities	\$ 2,585,095	\$ 2,606,816
Asset-backed securities	137,251	138,918
Commercial mortgage-backed securities	703,313	704,065
U.S. Government and agencies securities	240,952	256,168
State and political subdivision securities	27,297	27,555
Other foreign government, supranational, and foreign government-sponsored enterprises	56,776	55,437
<b>Total fixed maturity securities available for sale</b>	<b>3,750,684</b>	<b>3,788,959</b>

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Mortgage loans on real estate	1,009,454	1,021,661
Short-term investments	101,428	101,338
Cash and cash equivalents	501,593	501,593
Accrued interest	43,739	43,739
Total	\$ 5,406,898	\$ 5,457,290

The securities transferred to the Company related to the transaction are considered a non-cash transaction in the condensed consolidated statement of cash flows.



**Table of Contents****5. Derivative Instruments**

The following table presents the notional amounts and fair value of derivative instruments as of September 30, 2012 and December 31, 2011 (dollars in thousands):

	Notional Amount	September 30, 2012		Notional Amount	December 31, 2011		
		Carrying Value/ Assets	Fair Value Liabilities		Carrying Value/ Assets	Fair Value Liabilities	
<b>Derivatives not designated as hedging instruments:</b>							
Interest rate swaps <sup>(1)</sup>	\$ 2,236,718	\$ 306,774	\$ 174,741	\$ 2,748,317	\$ 184,842	\$ 18,702	
Financial futures <sup>(1)</sup>	204,424	--	--	277,814	--	--	
Foreign currency forwards <sup>(1)</sup>	44,400	4,052	36	24,400	4,560	--	
Consumer price index swaps <sup>(1)</sup>	102,742	817	--	101,069	766	--	
Credit default swaps <sup>(1)</sup>	640,500	1,308	3,770	649,500	1,313	10,949	
Equity options <sup>(1)</sup>	696,776	73,659	--	510,073	90,106	--	
Synthetic guaranteed investment contracts ( GIC <sup>(1)</sup> )	1,913,202	--	--	--	--	--	
<b>Embedded derivatives in:</b>							
Modified coinsurance or funds withheld arrangements <sup>(2)</sup>	--	--	320,501	--	--	361,456	
Indexed annuity products <sup>(3)</sup>	--	4,192	751,112	--	4,945	751,523	
Variable annuity products <sup>(3)</sup>	--	--	202,693	--	--	276,718	
<b>Total non-hedging derivatives</b>	<b>5,838,762</b>	<b>390,802</b>	<b>1,452,853</b>	<b>4,311,173</b>	<b>286,532</b>	<b>1,419,348</b>	
<b>Derivatives designated as hedging instruments:</b>							
Interest rate swaps <sup>(1)</sup>	57,181	3,901	--	56,250	133	960	
Foreign currency swaps <sup>(1)</sup>	629,512	--	32,757	621,578	286	23,996	
<b>Total hedging derivatives</b>	<b>686,693</b>	<b>3,901</b>	<b>32,757</b>	<b>677,828</b>	<b>419</b>	<b>24,956</b>	
<b>Total derivatives</b>	<b>\$ 6,525,455</b>	<b>\$ 394,703</b>	<b>\$ 1,485,610</b>	<b>\$ 4,989,001</b>	<b>\$ 286,951</b>	<b>\$ 1,444,304</b>	

(1) Carried on the Company's condensed consolidated balance sheets in other invested assets or other liabilities, at fair value.

(2) Embedded liability is included on the condensed consolidated balance sheets with the host contract in funds withheld at interest, at fair value.

(3) Embedded liability is included on the condensed consolidated balance sheets with the host contract in interest-sensitive contract liabilities, at fair value.

Embedded asset is included on the condensed consolidated balance sheets in reinsurance ceded receivables.

**Accounting for Derivative Instruments and Hedging Activities**

The Company does not enter into derivative instruments for speculative purposes. As discussed below under Non-qualifying Derivatives and Derivatives for Purposes Other Than Hedging, the Company uses various derivative instruments for risk management purposes that either do not qualify or have not been qualified for hedge accounting treatment, including derivatives used to economically hedge changes in the fair value of liabilities associated with the reinsurance of variable annuities with guaranteed living benefits. As of September 30, 2012 and December 31, 2011, the Company held interest rate swaps that were designated and qualified as cash flow hedges of interest rate risk. As of September 30, 2012 and December 31, 2011, the Company held foreign currency swaps that were designated and qualified as hedges of a portion of its net investment in its foreign operations. As of September 30, 2012 and December 31, 2011, the Company also had derivative instruments that were not designated as hedging instruments. See Note 2 Summary of Significant Accounting Policies of the Company's DAC Current Report for a detailed discussion of the accounting treatment for derivative instruments, including embedded derivatives. Derivative instruments are carried at fair value and generally require an insignificant amount of cash at inception of the contracts.

**Table of Contents****Fair Value Hedges**

During the fourth quarter of 2011 the Company removed the fair value hedge designation for its interest rate swaps. However, prior to the fourth quarter of 2011 the Company designated and accounted for certain interest rate swaps that convert fixed rate investments to floating rate investments as fair value hedges when they meet the requirements of the general accounting principles for *Derivatives and Hedging*. The gain or loss on the hedged item attributable to the hedged benchmark interest rate and the offsetting gain or loss on the related interest rate swaps for the three and nine months ended September 30, 2011 were (dollars in thousands):

Type of Fair Value Hedge	Hedged Item	Gains (Losses) Recognized for Derivatives	Gains (Losses) Recognized for Hedged Items	Ineffectiveness Recognized in Investment Related Gains (Losses)
<b>For the three months ended September 30, 2011:</b>				
Interest rate swaps	Fixed rate fixed maturities	\$ (655)	\$ 913	\$ 258
<b>For the nine months ended September 30, 2011:</b>				
Interest rate swaps	Fixed rate fixed maturities	\$ (921)	\$ 1,509	\$ 588

A regression analysis was used, both at the inception of the hedge and on an ongoing basis, to determine whether each derivative used in a hedge transaction is highly effective in offsetting changes in the hedged item. All components of each derivative's gain or loss were included in the assessment of hedge effectiveness.

**Cash Flow Hedges**

The Company designates and accounts for certain interest rate swaps, in which the cash flows are denominated in different currencies, commonly referred to as cross-currency swaps, as cash flow hedges when they meet the requirements of the general accounting principles for *Derivatives and Hedging*.

The following table presents the components of AOCI, before income tax, and the condensed consolidated income statement classification where the gain or loss is recognized related to cash flow hedges for the three and nine months ended September 30, 2012 (dollars in thousands):

	Three months ended September 30, 2012	Nine months ended September 30, 2012
Accumulated other comprehensive income (loss), balance beginning of period	\$ (719)	\$ (828)
Gains (losses) deferred in other comprehensive income (loss) on the effective portion of cash flow hedges	(2,831)	(2,044)
Amounts reclassified to investment related gains (losses), net	--	--
Amounts reclassified to investment income	(351)	(1,029)
Accumulated other comprehensive income (loss), balance end of period	\$ (3,901)	\$ (3,901)

As of September 30, 2012, the before-tax deferred net gains on derivative instruments recorded in AOCI that are expected to be reclassified to earnings during the next twelve months are \$0.8 million. This expectation is based on the anticipated interest payments on hedged investments in fixed maturity securities that will occur over the next twelve months, at which time the Company will recognize the deferred net gains (losses) as an adjustment to investment income over the term of the investment cash flows. There were no hedged forecasted transactions, other than the receipt or payment of variable interest payments on existing financial instruments, for the three and nine months ended September 30, 2012. The Company had no derivative instruments that were designated and qualified as cash flow hedges for the three and nine months ended September 30, 2011.

The following table presents the effects of derivatives in cash flow hedging relationships on the condensed consolidated statements of income and AOCI for the three and nine months ended September 30, 2012 (dollars in thousands):



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Derivatives in Cash Flow Hedging Relationships	Amount of Gains (Losses)	Amount and Location of Gains (Losses)		Amount and Location of Gains (Losses)	
	Deferred in AOCI on Derivatives	Reclassified from AOCI into Income (Loss)		Recognized in Income (Loss) on Derivatives (Ineffective Portion and Amounts Excluded from Effectiveness Testing)	
	(Effective Portion)	(Effective Portion)			
		Investment Related Gains (Losses)	Investment Income	Investment Related Gains (Losses)	Investment Income
<b>For the three months ended September 30, 2012:</b>					
Interest rate swaps	\$ (2,831)	\$ --	\$ 351	\$ (3)	\$ --
<b>For the nine months ended September 30, 2012:</b>					
Interest rate swaps	\$ (2,044)	\$ --	\$ 1,029	\$ --	\$ --

**Hedges of Net Investments in Foreign Operations**

The Company uses foreign currency swaps to hedge a portion of its net investment in certain foreign operations against adverse movements in exchange rates. The following table illustrates the Company's net investments in foreign operations (NIFO) hedges for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

Type of NIFO Hedge <sup>(1) (2)</sup>	Derivative Gains (Losses) Deferred in AOCI			
	For the three months ended		For the nine months ended	
	2012	2011	2012	2011
Foreign currency swaps	\$ (19,454)	\$ 50,974	\$ (23,457)	\$ 25,954

(1) There were no sales or substantial liquidations of net investments in foreign operations that would have required the reclassification of gains or losses from accumulated other comprehensive income (loss) into investment income during the periods presented.

(2) There was no ineffectiveness recognized for the Company's hedges of net investments in foreign operations.

The cumulative foreign currency translation gain (loss) recorded in AOCI related to these hedges was \$(19.4) million and \$4.1 million at September 30, 2012 and December 31, 2011, respectively. If a foreign operation was sold or substantially liquidated, the amounts in AOCI would be reclassified to the condensed consolidated statements of income. A pro rata portion would be reclassified upon partial sale of a foreign operation.

**Non-qualifying Derivatives and Derivatives for Purposes Other Than Hedging**

The Company uses various other derivative instruments for risk management purposes that either do not qualify or have not been qualified for hedge accounting treatment, including derivatives used to economically hedge changes in the fair value of liabilities associated with the reinsurance of variable annuities with guaranteed living benefits. The gain or loss related to the change in fair value for these derivative instruments is recognized in investment related gains (losses), in the condensed consolidated statements of income, except where otherwise noted. For the three months ended September 30, 2012 and 2011, the Company recognized investment related gains (losses) of \$(20.6) million and \$200.8 million, respectively, and \$(31.8) million and \$203.4 million for the nine months ended September 30, 2012 and 2011, respectively, related to derivatives (not including embedded derivatives) that do not qualify or have not been qualified for hedge accounting.

*Interest Rate Swaps*

Interest rate swaps are used by the Company primarily to reduce market risks from changes in interest rates and to alter interest rate exposure arising from mismatches between assets and liabilities (duration mismatches). With an interest rate swap, the Company agrees with another party to exchange, at specified intervals, the difference between two rates, which can be either fixed-rate or floating-rate interest amounts, tied to an agreed-upon notional principal amount. These transactions are executed pursuant to master agreements that provide for a single net payment or individual gross payments at each due date.

*Financial Futures*

Exchange-traded equity futures are used primarily to economically hedge liabilities embedded in certain variable annuity products. With exchange-traded equity futures transactions, the Company agrees to purchase or sell a specified number of contracts, the value of which is determined by the relevant stock indices, and to post variation margin on a daily basis in an amount equal to the difference between the daily estimated fair values of those contracts. The Company enters into exchange-traded equity futures with regulated futures commission merchants that are members of the exchange.

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### *Equity Options*

Equity index options are used by the Company primarily to hedge minimum guarantees embedded in certain variable annuity products. To hedge against adverse changes in equity indices volatility, the Company buys put options. The contracts are net settled in cash based on differentials in the indices at the time of exercise and the strike price.

### *Consumer Price Index Swaps*

Consumer price index ( CPI ) swaps are used by the Company primarily to economically hedge liabilities embedded in certain insurance products where value is directly affected by changes in a designated benchmark consumer price index. With a CPI swap transaction, the Company agrees with another party to exchange the actual amount of inflation realized over a specified period of time for a fixed amount of inflation determined at inception. These transactions are executed pursuant to master agreements that provide for a single net payment or individual gross payments to be made by the counterparty at each due date. Most of these swaps will require a single payment to be made by one counterparty at the maturity date of the swap.

### *Foreign Currency Swaps*

Foreign currency swaps are used by the Company to reduce the risk from fluctuations in foreign currency exchange rates associated with its assets and liabilities denominated in foreign currencies. With a foreign currency swap transaction, the Company agrees with another party to exchange, at specified intervals, the difference between one currency and another at a forward exchange rate calculated by reference to an agreed upon principal amount. The principal amount of each currency is exchanged at the inception and termination of the currency swap by each party. The Company may also use foreign currency swaps to economically hedge the foreign currency risk associated with certain of its net investments in foreign operations.

### *Foreign Currency Forwards*

Foreign currency forwards are used by the Company to reduce the risk from fluctuations in foreign currency exchange rates associated with its assets and liabilities denominated in foreign currencies. With a foreign currency forward transaction, the Company agrees with another party to deliver a specified amount of an identified currency at a specified future date. The price is agreed upon at the time of the contract and payment for such a contract is made in a different currency at the specified future date.

### *Credit Default Swaps*

The Company sells protection under single name credit default swaps and credit default swap index tranches to diversify its credit risk exposure in certain portfolios and, in combination with purchasing securities, to replicate characteristics of similar investments based on the credit quality and term of the credit default swap. Credit default triggers for indexed reference entities and single name reference entities are defined in the contracts. The Company's maximum exposure to credit loss equals the notional value for credit default swaps. In the event of default for credit default swaps, the Company is typically required to pay the protection holder the full notional value less a recovery rate determined at auction.

The Company's maximum amount at risk on credit default swaps, assuming the value of the underlying referenced securities is zero, was \$622.5 million and \$614.0 million at September 30, 2012 and December 31, 2011, respectively.

The Company also purchases credit default swaps to reduce its risk against a drop in bond prices due to credit concerns of certain bond issuers. If a credit event, as defined by the contract, occurs, the Company is able to put the bond back to the counterparty at par.

### *Synthetic GICs*

The Company sells fee-based synthetic GICs which include investment-only, stable value contracts, to retirement plans. The assets are owned by the trustees of such plans, who invest the assets under the terms of investment guidelines agreed to with the Company. The contracts contain a guarantee of a minimum rate of return on participant balances supported by the underlying assets, and a guarantee of liquidity to meet certain participant-initiated plan cash flow requirements. These contracts are accounted for as derivatives, recorded at fair value and classified as interest rate derivatives.

### *Embedded Derivatives*

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The Company has certain embedded derivatives which are required to be separated from their host contracts and reported as derivatives. Host contracts include reinsurance treaties structured on a modified coinsurance ( modco ) or funds withheld basis. Changes in fair values of embedded derivatives on modco or funds withheld treaties are net of an increase (decrease) in investment related gains, net of \$(6.2) million and \$25.4 million for the three months and \$(63.4) million and \$1.1 million for the nine months ended September 30, 2012 and 2011, respectively, associated with the Company's own credit risk. Changes in fair values of embedded derivatives on variable annuity contracts are net of an increase (decrease) in investment related gains (losses), net of \$(28.3) million and \$23.2 million for the three and nine months ended September 30, 2012,

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respectively, associated with the Company's own credit risk. Additionally, the Company reinsures equity-indexed annuity and variable annuity contracts with benefits that are considered embedded derivatives, including guaranteed minimum withdrawal benefits, guaranteed minimum accumulation benefits, and guaranteed minimum income benefits. The related gains (losses) and the effect on net income after amortization of deferred acquisition costs ( DAC ) and income taxes for the three months ended September 30, 2012 and 2011 are reflected in the following table (dollars in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Embedded derivatives in modco or funds withheld arrangements included in investment related gains	\$ 54,836	\$ (102,574)	\$ 40,955	\$ (1,514)
After the associated amortization of DAC and taxes, the related amounts included in net income	11,228	(22,403)	10,563	568
Embedded derivatives in variable annuity contracts included in investment related gains	2,579	(260,239)	74,025	(253,445)
After the associated amortization of DAC and taxes, the related amounts included in net income	1,588	(25,263)	494	(23,876)
Amounts related to embedded derivatives in equity-indexed annuities included in benefits and expenses	(33,821)	14,360	(26,422)	(58,987)
After the associated amortization of DAC and taxes, the related amounts included in net income	(22,529)	23,002	6,465	(26,840)

*Non-hedging Derivatives*

A summary of the effect of non-hedging derivatives, including embedded derivatives, on the Company's income statement for the three and nine months ended September 30, 2012 and 2011 is as follows (dollars in thousands):

Type of Non-hedging Derivative	Gain (Loss) for the Three Months Ended September 30,	
	2012	2011
Interest rate swaps	Investment related gains (losses), net	\$ (1,437) \$ 142,907
Financial futures	Investment related gains (losses), net	(3,977) 36,217
Foreign currency forwards	Investment related gains (losses), net	519 1,374
CPI swaps	Investment related gains (losses), net	422 (219)
Credit default swaps	Investment related gains (losses), net	7,817 (10,018)
Equity options		(23,916) 30,530



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	Investment related gains (losses), net		
Embedded derivatives in:			
Modified coinsurance or funds withheld arrangements	Investment related gains (losses), net	54,836	(102,574)
Indexed annuity products	Policy acquisition costs and other insurance expenses	(224)	(3,172)
Indexed annuity products	Interest credited	(33,597)	17,531
Variable annuity products	Investment related gains (losses), net	2,579	(260,239)
Total non-hedging derivatives		\$ 3,022	\$ (147,663)

Type of Non-hedging Derivative	Income Statement Location of Gain (Loss)	Gain (Loss) for the Nine Months Ended September 30,	
		2012	2011
Interest rate swaps	Investment related gains (losses), net	\$ 24,553	\$ 157,520
Financial futures	Investment related gains (losses), net	(10,312)	21,920
Foreign currency forwards	Investment related gains (losses), net	(574)	1,114

Subscriber growth also contributed to the increase in net revenues in 2002. The number of subscribers increased from 45.5 million in 2001 to 53.8 million in 2002 (including Virgin Mobile subscribers of 1.4 million in 2001 and 2.4 million in 2002). This increase was mainly a result of strong subscriber growth in the United States and, to a lesser extent, through subscriber growth in Europe and the consolidation of T-Mobile Netherlands in September 2002.

Net revenues increased by EUR 4,000 million, or 44.5%, to EUR 12,994 million in 2001 from EUR 8,994 million in 2000. T-Mobile USA/ Powertel, acquired in May 2001, accounted for EUR 2,796 million of this increase, and RadioMobil, consolidated since March 31, 2001, accounted for EUR 483 million of this increase. Without giving effect to the consolidations of T-Mobile USA/ Powertel and RadioMobil, net revenues of the T-Mobile segment increased by EUR 709 million, or 7.9%, largely due to increases in the number of mobile subscribers of T-Mobile Deutschland in Germany and T-Mobile UK in the United Kingdom.

***Total Revenues***

Total revenues include both net revenues from external customers and revenues from transactions with other segments within the Deutsche Telekom group. The most significant component of inter-segment revenues for T-Mobile relates to revenues received from our T-Com division for terminating calls on the mobile network in Germany that originated from T-Com's fixed-line network in Germany.

Inter-segment revenues decreased by EUR 137 million, or 8.3%, to EUR 1,506 million in 2002 from EUR 1,643 million in 2001. This decrease was primarily due to a decline in the rates charged for terminating calls from the fixed-line network. Inter-segment revenues increased by EUR 281 million, or 20.6%, to EUR 1,643 million in 2001 from EUR 1,362 million in 2000. This increase was primarily due to the growth of the subscriber base and a corresponding increase in revenues received from T-Com for terminating calls on the mobile network. Substantially all inter-segment revenues are received through T-Mobile Deutschland.

Although revenues from mobile data services (other than SMS) are not currently significant, T-Mobile expects that these services will represent an important source of future growth. In order to encourage usage of

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these services, T-Mobile has announced significant price reductions for these services effective April 15, 2003.

**Subscribers**

The following table reflects the number of T-Mobile subscribers by subsidiary.

Subsidiary	As of December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(Subscribers in millions)			(% change)	
T-Mobile Deutschland	24.6	23.1	19.1	6.5%	20.9%
T-Mobile UK <sup>(1)</sup>	12.4	10.4	8.3	19.2%	25.3%
T-Mobile USA/ Powertel <sup>(2)</sup>	9.9	7.0		41.4%	n/a
T-Mobile Austria	2.0	2.1	2.0	(4.8)%	5.0%
RadioMobil <sup>(3)</sup>	3.5	2.9		20.7%	n/a
T-Mobile Netherlands <sup>(4)</sup>	1.4			n/a	n.m
<b>Total</b>	<b>53.8</b>	<b>45.5</b>	<b>29.4</b>	<b>18.2%</b>	<b>54.8%</b>

(1) Including Virgin Mobile subscribers of 2.4 million for 2002, 1.4 million for 2001 and 0.7 million for 2000.

(2) First consolidated May 31, 2001.

(3) First consolidated March 31, 2001.

(4) First consolidated September 30, 2002.

The figures above represent the total number of contract and prepaid subscribers at year-end for the periods presented. For further information relating to subscriber data, see Item 4. Information on the Company Description of Business Divisions T-Mobile.

T-Mobile expects that the number of subscribers in European markets will not grow significantly in the future, as most of the markets in Europe are relatively mature and at or near saturation. T-Mobile expects that the number of subscribers in the U.S. market will continue to increase as that market has not yet reached saturation, although usage patterns may differ from those prevalent in Europe.

**Total Revenues by Geographic Area**

The following table reflects T-Mobile's total revenues by geographic area.

	For the year ended December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
<b>Total revenues:</b>					
Germany	7,777	7,064	6,475	10.1%	9.1%
North America <sup>(1)</sup>	6,124	2,796		119.0%	n/a
United Kingdom	3,990	3,277	2,883	21.8%	13.7%
Austria	985	1,017	998	(3.1)%	1.9%
Czech Republic <sup>(2)</sup>	698	483		44.5%	n/a
Netherlands <sup>(3)</sup>	158			n/a	n/a

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Other	3	_____	_____		
<b>Total</b>	19,735	14,637	10,356	34.8%	41.3%
	_____	_____	_____		

- 
- (1) First consolidated May 31, 2001.
  - (2) First consolidated March 31, 2001.
  - (3) First consolidated September 30, 2002.

The following discussions provide additional revenue information by geographic area. Total revenues include revenues from activation fees, monthly and daily access fees, call and other charges paid by direct subscribers, charges paid by resellers, interconnection fees and international roaming fees paid by other network carriers.

**Table of Contents***Germany***For the year ended December 31,**

	2002		2001		2000		2002/2001	2001/2000
	(millions of euro, except percentages)						(% change)	
Mobile communications revenues	7,040	90.5%	6,431	91.0%	5,416	83.6%	9.5%	18.7%
Handset sales	692	8.9%	579	8.2%	1,015	15.7%	19.5%	(43.0)%
Other revenues	45	0.6%	54	0.8%	44	0.7%	(16.7)%	23.0%
<b>Total revenues</b>	<b>7,777</b>	<b>100.0%</b>	<b>7,064</b>	<b>100.0%</b>	<b>6,475</b>	<b>100.0%</b>	<b>10.1%</b>	<b>9.1%</b>

Mobile communications revenues in Germany, through T-Mobile Deutschland, increased by 9.5% in 2002 as compared to 2001. Inter-segment revenues, primarily resulting from the termination of calls from T-Com s fixed-line network customers in Germany, decreased by EUR 157 million, or 10.7%, to EUR 1,379 million in 2002 from EUR 1,536 million in 2001. This decrease was primarily due to a decline in the rates charged for terminating calls from the fixed-line network. The increase in mobile communications revenues was primarily caused by an increase in the number of subscribers. This increase in revenues resulting from the increase in the number of subscribers was offset in part by the decrease in inter-segment revenues in 2002.

As of December 31, 2002, T-Mobile Deutschland had approximately 24.6 million subscribers, as compared to approximately 23.1 million subscribers as of December 31, 2001. Of the total subscribers as of December 31, 2002, approximately 11.5 million were contract subscribers, as compared to approximately 10.7 million as of December 31, 2001. T-Mobile Deutschland had approximately 13.1 million prepay subscribers at December 31, 2002, as compared to approximately 12.4 million as of December 31, 2001. This represents a slight increase of contract subscribers (0.8 million) and prepay subscribers (0.7 million) compared to December 31, 2001.

T-Mobile Deutschland s revenues from handset sales increased in 2002 compared to 2001 mainly due to the sale of more expensive handsets, such as handsets with multimedia messaging services ( MMS ) capabilities. In 2002, the effect of higher average handset selling prices (through reduced handset subsidies) in combination with the number of handsets sold to subscribers who extended their contracts more than offset the lower number of new contracts and new prepay account activations in 2002 compared to 2001.

Revenues from mobile communications in Germany increased by 18.7% in 2001 as compared to 2000. Inter-segment revenues increased by 24.4% to EUR 1,536 million in 2001 from EUR 1,235 million in 2000. The increase in external and inter-segment revenues was driven largely by a 20.9% increase in the subscriber base from 2001 as compared to 2000. Revenues from handset sales decreased by 43.0% in 2001 as compared to 2000, mainly due to a 36.9% decrease in gross subscriber additions in 2001 as compared to 2000.

*North America***For the year ended December 31,<sup>(1)</sup>**

	2002		2001		2002/2001
	(millions of euro, except percentages)				(% change)
Mobile communications revenues	5,292	86.4%	2,494	89.2%	112.2%

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Handset sales	819	13.4%	297	10.6%	175.8%
Other revenues	13	0.2%	5	0.2%	160.0%
	<hr/>	<hr/>	<hr/>	<hr/>	
<b>Total</b>	6,124	100.0%	2,796	100.0%	119.0%
	<hr/>	<hr/>	<hr/>	<hr/>	

(1) This table presents the combined total consolidated revenues of our wholly-owned U.S. subsidiaries, T-Mobile USA, Inc. and Powertel, Inc. The revenues presented for 2001 are only with respect to the last seven months of 2001, which is the period during which these companies were consolidated within our group.

Mobile communications revenues in North America increased EUR 2,798 million, or 112.2%, to EUR 5,292 million in 2002 compared to EUR 2,494 million in 2001. North American operations were consolidated for a full twelve months in 2002 and seven months in 2001. Aside from this consolidation effect, the increase in North American mobile communications revenues resulted primarily from an increase in subscribers. At December 31, 2002, total subscribers in North America increased to approximately 9.9 million, as compared to approximately 7.0 million at December 31, 2001, representing an increase of 41.4%. During 2002, coverage was expanded into several new markets, most significantly the California/

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Nevada market in the United States. The introduction of services in these markets was accompanied by promotional rate plan offers that contributed to the high number of subscribers added during the year. The high rate of net contract customer growth (gross contract subscriber additions rate minus the churn rate of contract subscribers) in 2002 also reflects higher growth in the number of new subscribers in existing markets due to competitive rate plan offerings, the success of advertising, the T-Mobile rebranding campaigns and lower customer churn rates as compared to 2001.

Revenues from handset sales in North America increased by EUR 522 million to EUR 819 million in 2002 compared to EUR 297 million in 2001, primarily as a result of growth in gross subscriber additions of 23.0% and the full-year consolidation in 2002.

*United Kingdom***For the year ended December 31,**

	2002		2001		2000		2002/2001	2001/2000
	(millions of euro, except percentages)						(% change)	
Mobile communications revenues	3,540	88.7%	2,870	87.6%	2,476	85.9%	23.3%	15.9%
Handset sales	429	10.8%	393	12.0%	407	14.1%	9.2%	(3.4)%
Other revenues	21	0.5%	14	0.4%			50.0%	
<b>Total</b>	<b>3,990</b>	<b>100.0%</b>	<b>3,277</b>	<b>100.0%</b>	<b>2,883</b>	<b>100.0%</b>	<b>21.8%</b>	<b>13.7%</b>

Mobile communications revenues in the United Kingdom, through T-Mobile UK, increased by EUR 670 million, or 23.3%, to EUR 3,540 million in 2002 compared to EUR 2,870 million in 2001, due primarily to an increase in subscribers. At December 31, 2002, T-Mobile UK had approximately 12.4 million subscribers (including 2.4 million subscribers of Virgin Mobile), as compared to approximately 10.4 million at December 31, 2001, an increase of 19.2%. T-Mobile UK's revenues from handset sales increased in 2002 compared to 2001, mainly due to higher average revenue per handset sale.

Mobile communications revenues increased by 15.9% in 2001 compared to 2000. This increase resulted primarily from the increase of 25.3% in the number of subscribers. In 2001, revenues from handset sales decreased compared to 2000 as a result of lower gross subscriber additions.

*Austria***For the year ended December 31,**

	2002		2001		2000		2002/2001	2001/2000
	(millions of euro, except percentages)						(% change)	
Mobile communications revenues	723	73.4%	758	74.5%	693	69.5%	(4.6)%	9.4%
Handset sales	116	11.8%	112	11.0%	162	16.2%	3.6%	(30.9)%
Other revenues	146	14.8%	147	14.5%	143	14.3%	(0.7)%	2.8%
<b>Total</b>	<b>985</b>	<b>100.0%</b>	<b>1,017</b>	<b>100.0%</b>	<b>998</b>	<b>100.0%</b>	<b>(3.1)%</b>	<b>1.9%</b>



Mobile communications revenues from our Austrian mobile communications operations, through T-Mobile Austria, decreased by EUR 35 million, or 4.6%, to EUR 723 million in 2002 from EUR 758 million in 2001. This decrease was due primarily to a decrease in the number of subscribers as a consequence of the highly saturated mobile phone market in Austria and some decline in market share. As of December 31, 2002, T-Mobile Austria had approximately 2.0 million mobile communications subscribers, compared to 2.1 million at December 31, 2001. In 2002, revenues from handset sales remained stable as a result of mobile market saturation.

Revenues from mobile communications increased by 9.4% in 2001 compared to 2000. The increase resulted primarily from an increase in the number of subscribers of approximately 5.0%. T-Mobile Austria's revenues from handset sales decreased in 2001 compared to 2000, mainly due to a reduced number of gross subscriber additions.

Other revenues is primarily derived from revenues we receive from the sale of non-telecommunications products and services sold through Niedermeyer, an Austrian electronics retail chain owned by T-Mobile Austria, the sales of which remained relatively constant from 2000 to 2002.



**Table of Contents***Czech Republic*For the year ended December 31,<sup>(1)</sup>

	2002		2001		2002/2001
	(millions of euro, except percentages)				(% change)
Mobile communications revenues	668	95.7%	441	91.4%	51.5%
Handset sales	30	4.3%	21	4.3%	42.9%
Other revenues			21	4.3%	(100.0)%
<b>Total</b>	<b>698</b>	<b>100.0%</b>	<b>483</b>	<b>100.0%</b>	<b>44.5%</b>

(1) The revenues presented for 2001 are only with respect to the last nine months of 2001, the period during which RadioMobil was consolidated within our group.

Mobile communications revenues in the Czech Republic, through RadioMobil, increased by EUR 227 million, or 51.5%, to EUR 668 million in 2002 from EUR 441 million for the period from April 1, 2001 through December 31, 2001. The increase in mobile communications revenues from 2001 to 2002 resulted primarily from twelve months of fully consolidated results in 2002 as compared to nine months in 2001 and an increase in the number of subscribers to 3.5 million at December 31, 2002, from 2.9 million at December 31, 2001. Of the total subscriber base at December 31, 2002, 19.1% were contract subscribers which is an increase of 3.4% from December 31, 2001, and reflects RadioMobil's continued efforts to increase the contract subscriber share by marketing attractive migration offers to prepay subscribers. RadioMobil was also able to increase the share of business subscribers within the customer base. Despite the increases in the share of contract subscribers and business subscribers in the subscriber base, there was a decline in average usage per subscriber as a consequence of an increasing share of lower-usage subscribers in the subscriber base following the rise in penetration to 85%, an increase of 43 percentage points from December 31, 2000 through December 31, 2002.

*Netherlands*

Revenues from our Dutch operations, through T-Mobile Netherlands, which were fully consolidated for the last 3 months of 2002, included EUR 151 million of mobile communications revenues and EUR 7 million of handset sales revenues. At December 31, 2002, T-Mobile Netherlands had approximately 1.4 million subscribers.

*Operating Expenses*

The following table provides information regarding components of operating expenses in our T-Mobile segment.

For the year ended December 31,

	2002		2001		2000		2002/2001	2001/2000
	(millions of euro, except percentages)				(% change)			
Goods and services purchased	6,673	15.5%	5,173	27.8%	5,030	41.9%	29.0%	2.8%
Personnel costs	2,176	5.1%	1,650	8.9%	870	7.2%	31.9%	89.7%
Depreciation and amortization	27,285	63.3%	6,324	34.0%	2,337	19.5%	331.5%	170.6%
	6,951	16.1%	5,463	29.3%	3,765	31.4%	27.2%	45.1%

Other operating expenses

	2002	%	2001	%	2000	%	2000	%
<b>Total</b>	43,085	100.0%	18,610	100.0%	12,002	100.0%	131.5%	55.1%

Goods and services purchased include the purchases of goods such as mobile handsets and SIM cards, as well as the costs of services purchased, such as line rental and interconnection charges, international roaming charges, data processing charges, maintenance and other support services and information technology services. Goods and services purchased increased by EUR 1,500 million, or 29.0%, to EUR 6,673 million in 2002 from EUR 5,173 million in 2001. The increase was mainly attributable to the consolidation of T-Mobile USA/ Powertel for a full twelve months in 2002 compared to seven months in 2001, the consolidation of RadioMobil for a full twelve months in 2002 compared to nine months in 2001, and the consolidation of T-Mobile Netherlands for the period from September 30, 2002 through December 31, 2002. Subscriber growth and the related increase in traffic also contributed to the increase in goods and services purchased.

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Goods and services purchased increased by EUR 143 million, or 2.8%, to EUR 5,173 million in 2001 from EUR 5,030 million in 2000. The consolidation of T-Mobile USA/ Powertel for seven months in 2001 and the consolidation of RadioMobil for nine months in 2001 led to an increase in goods and services purchased. Subscriber growth and the related increase in traffic also contributed to the increase in goods and services purchased. These increases were offset by declines in volumes of handsets as a result of the decline in additional new subscribers, and in the per unit cost of handsets. In addition, beginning in mid-2001, T-Mobile Deutschland changed its policy for compensating retailers for prepaid subscribers, reducing handset subsidies and increasing commissions paid. As a result of the reduction of handset subsidies, the amount of inventory writedowns, recognized as goods and services purchased, declined and commissions, included in other operating expenses, increased.

Personnel costs in our T-Mobile segment primarily consist of wages and salaries, but also include social security, pension costs and other employee benefits. Personnel costs increased by EUR 526 million, or 31.9%, to EUR 2,176 million in 2002 from EUR 1,650 million in 2001. The increase is in part the result of the first full-year consolidation of T-Mobile USA/ Powertel and RadioMobil, as well as the three months consolidation of T-Mobile Netherlands. T-Mobile USA/ Powertel accounted for an aggregate of EUR 424 million to the increase in personnel costs in 2002. The increase in personnel costs was also attributable to an increase in the annual average number of employees, primarily at T-Mobile USA/ Powertel. The number of full-time employees increased 9.2% from 38,025 to 41,511 from December 31, 2001 to December 31, 2002. T-Mobile USA/ Powertel added 2,168 employees to its workforce during 2002, and the first time inclusion of T-Mobile Netherlands increased the total number of employees by 1,467.

Of the increase of EUR 780 million in personnel costs in 2001, as compared with 2000, EUR 573 million was attributable to the first time inclusion of T-Mobile USA/ Powertel during 2001. The consolidation of RadioMobil contributed EUR 25 million to 2001 personnel costs. Excluding amounts attributable to T-Mobile USA/ Powertel and RadioMobil, personnel costs increased by EUR 182 million, or 20.9%, in 2001 compared with 2000, primarily as a result of an increase in the average workforce. The workforces of T-Mobile USA/ Powertel and RadioMobil also increased during the periods for which they were consolidated in 2001.

The following table provides information regarding depreciation and amortization for the T-Mobile segment.

	For the year ended December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
Nonscheduled amortization of intangible assets	20,810	1,040		n.m	n.m
Scheduled amortization of intangible assets	4,339	3,409	1,381	27.3%	146.9%
Depreciation of property, plant and equipment	2,136	1,875	956	13.9%	96.1%
<b>Total</b>	<b>27,285</b>	<b>6,324</b>	<b>2,337</b>	<b>331.5%</b>	<b>170.6%</b>

Depreciation and amortization increased to EUR 27,285 million in 2002, primarily as a result of nonscheduled amortization of EUR 8,288 million relating to goodwill at T-Mobile USA/ Powertel, EUR 958 million relating to goodwill at T-Mobile Netherlands, EUR 9,384 million relating to FCC licenses at T-Mobile USA/ Powertel, and EUR 2,165 million relating to our UMTS license at T-Mobile UK. The nonscheduled amortization recognized in 2002 was a result of the group-wide strategic review. In the strategic review, a cash flow-based analysis of these licenses and goodwill was performed. The assumptions regarding middle and long-term business development prospects were reassessed in light of changes in current competitive conditions, future expectations of growth in the wireless communications industry, increased costs of capital and changes in the future availability of financing. For more information on the results of the strategic review, see

Effects of Acquisitions, Dispositions and Nonscheduled Depreciation and Amortization on Our Statements of

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Operations for the Three Years Ended December 31, 2002. In 2001, we recognized nonscheduled amortization of EUR 1,040 million relating to the goodwill associated with the brand names acquired with T-Mobile UK and T-Mobile Austria.

Scheduled amortization of intangible assets increased by 27.3% in 2002 compared to 2001, due primarily to the inclusion of a full year of amortization relating to T-Mobile USA/ Powertel in 2002 compared to seven months in 2001. The increase in scheduled amortization of intangible assets in 2001 compared to 2000 resulted primarily from the inclusion of seven months of amortization relating to T-Mobile USA/ Powertel in 2001 and from the full year amortization of UMTS licenses in 2001. The UMTS licenses in Germany, the

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United Kingdom and Austria, acquired during 2000, were subject to only a partial year of amortization in 2000.

Depreciation of property, plant and equipment increased by 13.9% during 2002 compared to 2001, due primarily to the inclusion of a full year of depreciation for T-Mobile USA/ Powertel compared to seven months in 2001 and increases in the asset base as a result of continuing capital expenditures. The increase in depreciation in 2001 compared to 2000 resulted primarily from the inclusion of seven months of depreciation for T-Mobile USA/ Powertel in 2001. In addition, during 2001, following a review of asset lives and work-in-progress, we recognized EUR 104 million of nonscheduled depreciation.

Other operating expenses consist of commissions paid to resellers and third-party distributors, marketing (including advertising) expenses, rent and associated expenses, administrative expenses such as costs of IT services, allowances and writedowns for doubtful accounts and other miscellaneous items, such as overhead expenses, general maintenance and repair expenses, legal and consulting fees, expenses for outsourcing and temporary staff. Costs relating to commissions, marketing and advertising are the most significant of these costs, representing 46.4% of total other operating expenses in 2002.

The following table provides information regarding other operating expenses:

	For the year ended December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
Commissions, marketing and advertising expenses	3,222	2,503	2,202	28.7%	13.7%
Rental and leasing expenses	1,097	715	434	53.4%	64.7%
Administrative expenses	410	424	320	(3.3)%	32.5%
Losses on accounts receivable and provision for doubtful accounts	387	403	164	(4.0)%	145.7%
Maintenance, repairs and damage reparation	265	221	166	19.9%	33.1%
Legal and consulting fees	183	136	86	34.6%	58.1%
Power, electricity and water expenses	172	142	105	21.1%	35.2%
Other employee-related costs	163	174	109	(6.3)%	59.6%
Other expenses	1,052	745	179	41.2%	316.2%
<b>Total</b>	<b>6,951</b>	<b>5,463</b>	<b>3,765</b>	<b>27.2%</b>	<b>45.1%</b>

The increase in total other operating expenses from 2001 to 2002 is primarily attributable to the full-year inclusion of T-Mobile USA/ Powertel which contributed almost EUR 3 billion, or 42.5%, of other operating expenses in 2002 as compared to EUR 1.6 billion, or 30.1%, in 2001. The increase in commissions, marketing and advertising expenses is mainly due to increases in subscribers and the full-year consolidation of T-Mobile USA/ Powertel. Rental and leasing expenses, which mainly relate to cellular and other telecommunication site rentals, increased by 53.4% from 2001 to 2002, and by 64.7% from 2000 to 2001. These increases are also attributable to the expansion of the T-Mobile group in 2001.

Of the increase in other operating expenses from 2000 to 2001, the inclusion of T-Mobile USA/ Powertel for the seven-month period ended December 31, 2001 accounted for 96.8% of such increase, and the first time consolidation of RadioMobil from April 2001 accounted for 7.2%. Excluding T-Mobile USA/ Powertel and RadioMobil, other operating expenses decreased by 1.8%, or EUR 68 million, in 2001.

Not including T-Mobile/ Powertel, the decrease in subscriber growth rates in 2001 as compared with 2000 resulted in a decrease of EUR 175 million, or 16.4%, of T-Mobile Deutschland's commissions, marketing and advertising expenses. This decrease was partially offset by higher commissions for prepaid tariff packages in 2001 instead of subsidizing the sale of mobile handsets included in such packages. T-Mobile Austria

experienced a decrease in commissions and advertising expenses of EUR 237 million and T-Mobile UK experienced a decrease of EUR 69 million in commissions and advertising expenses also primarily due to the decrease in subscriber growth rates in 2001. These decreases were partly offset by increases in miscellaneous other operating expenses.

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The following table presents information concerning the financial income (expense), net of our T-Mobile segment:

	For the year ended December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
Income (loss) from companies accounted for under the equity method	(355)	(204)	(69)	74.0%	195.7%
Writedowns on financial assets and marketable securities	(72)		(58)	n.m.	100%
<b>Income (loss) from financial activities</b>	<b>(427)</b>	<b>(204)</b>	<b>(127)</b>	<b>109.3%</b>	<b>60.6%</b>
Net interest expense	(1,005)	(3,008)	(1,370)	(66.6)%	119.6%
<b>Total</b>	<b>(1,432)</b>	<b>(3,212)</b>	<b>(1,497)</b>	<b>(55.4)%</b>	<b>114.6%</b>

Financial income (expense), net consists of:

income (loss) from affiliates accounted for under the equity method and investments, plus interest and other income from securities and loans to affiliates;

less interest expense (including interest payable to affiliates) and other expenses incurred in connection with borrowings; and

less writedowns on investments accounted for under the equity method and other financial assets.

Loss from companies accounted for under the equity method increased to EUR 355 million in 2002, primarily due to losses of EUR 292 million relating to T-Mobile Netherlands, reflecting the nine-month period during which T-Mobile Netherlands was accounted for as an equity investment. This loss for 2002 also included EUR 171 million relating to the nonscheduled amortization of the T-Mobile Netherlands UMTS license, EUR 40 million of goodwill amortization and EUR 81 million relating to T-Mobile's portion of the losses of T-Mobile Netherlands. In addition, losses from equity investments of T-Mobile USA, Inc. amounted to EUR 173 million during 2002. These losses were partially offset by income related to MTS in the amount of EUR 99 million.

Loss from companies accounted for under the equity method increased to EUR 204 million in 2001 as compared to 2000, primarily due to EUR 111 million relating to losses of T-Mobile Netherlands and EUR 54 million in amortization of the goodwill recorded for the acquisition of the interest in T-Mobile Netherlands as compared to 2000 combined losses related to T-Mobile Netherlands of EUR 34 million for the three-month period from October through December 2000. Losses from equity investments held by T-Mobile USA, Inc. added losses aggregating EUR 53 million in 2001.

Net interest expense decreased significantly from 2001 to 2002, primarily due to the conversion of Deutsche Telekom AG loans in the amount of EUR 38 billion and related accrued interest to shareholders' equity effective December 31, 2001. A redemption premium of EUR 569 million was paid to Deutsche Telekom AG in 2001 relating to this conversion. Net interest expense increased significantly from 2000 to 2001, principally due to loans received from Deutsche Telekom AG and Deutsche Telekom group companies. In addition, EUR 307 million of net interest expense is attributable to the consolidation of T-Mobile USA/ Powertel in 2001 and EUR 18 million of net interest expense is attributable to the consolidation of RadioMobil in 2001.

**Income (Loss) before Taxes**

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The loss before taxes at the T-Mobile segment of EUR 23,679 million represented a EUR 17,280 million increase from 2001. This increase was primarily a result of nonscheduled amortization on licenses and goodwill of EUR 20,810 million, primarily relating to T-Mobile USA/ Powertel and T-Mobile UK. The increase of EUR 5,098 million in total revenue, the increase in operating expenses, excluding the effects of the nonscheduled amortization on licenses and goodwill, of EUR 4,705 million, and the decrease in financial expense of EUR 1,780 million, primarily due to the decline in net interest expense of EUR 2,003 million, also affected the change in the net loss.

Loss before taxes amounted to EUR 6,399 million in 2001, representing an increase of EUR 4,049 million, or 172%, compared to 2000. Of this increase, the first-time consolidation of T-Mobile USA/ Powertel starting in June 2001 accounted for EUR 2,765 million. Depreciation and amortization of the T-Mobile segment increased substantially due to several important factors: goodwill amortization relating to



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T-Mobile USA/ Powertel (EUR 882 million); nonscheduled amortization of trademarks acquired with T-Mobile UK and T-Mobile Austria which accompanied T-Mobile's rebranding campaign (EUR 1,040 million) and the first time inclusion of amortization of UMTS licenses in results for a full year in 2001 (EUR 724 million). These effects were partially offset, however, by substantially increased revenues and by a reduction in subsidies on mobile handsets, advertising costs and commissions for vendors of T-Mobile's services compared to 2000.

**T-Online**

Our T-Online division includes the Internet services activities of our majority-owned subsidiary, T-Online International AG, and the online and print telephone directory advertising activities of our wholly owned subsidiary, DeTeMedien. On January 1, 2003, DeTeMedien's activities were transferred to our T-Com division. As a consequence, the results of those activities will no longer be reflected in the T-Online division.

The following table presents selected financial information concerning T-Online.

	<b>For the year ended December 31,</b>				
	<b>2002</b>	<b>2001</b>	<b>2000</b>	<b>2002/2001</b>	<b>2001/2000</b>
	(millions of euro)			(% change)	
Internet Services	1,584	1,140	797	38.9%	43.0%
Directory advertising	319	348	367	(8.3)%	(5.2)%
Less intra-segment revenues	(73)	(39)	(36)	87.2%	8.3%
<b>Total revenues</b>	<b>1,830</b>	<b>1,449</b>	<b>1,128</b>	<b>26.3%</b>	<b>28.5%</b>
Less inter-segment revenues	(158)	(111)	(90)	42.3%	23.3%
<b>Net revenues</b>	<b>1,672</b>	<b>1,338</b>	<b>1,038</b>	<b>25.0%</b>	<b>28.9%</b>
<b>Income (loss) before taxes</b>	<b>9</b>	<b>(233)</b>	<b>2,628</b>	<b>103.4%</b>	<b>(108.9)%</b>

**Revenues**

The net revenues of the T-Online division (total revenues excluding inter-segment revenues) increased to EUR 1.7 billion in 2002 from EUR 1.3 billion in 2001 and EUR 1.0 billion in 2000. The increase in both net and total revenues in the T-Online division over this period related mainly to growth in the number of Internet access subscribers and, to a smaller degree, an increase in non-access revenues at T-Online International AG.

**Components of T-Online Revenues**

The revenues of the T-Online division have been derived principally from Internet services, including access and non-access services, and directory advertising.

*Internet Services Revenues*

	<b>For the year ended December 31,</b>				
	<b>2002</b>	<b>2001</b>	<b>2000</b>	<b>2002/2001</b>	<b>2001/2000</b>
	(millions of euro)			(% change)	
Access	1,245	947	666	31.5%	42.2%
Non-access	339	193	131	75.6%	47.3%

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<b>Total revenues from Internet services</b>	1,584	1,140	797	38.9%	43.0%
Less intra- and inter-segment revenues	(193)	(113)	(84)	70.7%	34.5%
	<u>          </u>	<u>          </u>	<u>          </u>		
<b>Net revenues</b>	1,391	1,027	713	35.4%	44.0%

The T-Online's division's access revenues are generated by Internet access fees, such as monthly charges, time-based usage charges and other charges to Internet access subscribers. Access revenues increased in each of 2002 and 2001 as compared to the preceding year. These increases were attributable principally to growth in the number of subscribers, to 12.2 million in 2002 from 10.7 million in 2001 and 7.9 million in 2000, and, to a lesser degree, to changes in service offerings and pricing, which resulted in higher average revenues per user. During 2002, T-Online International AG replaced its narrowband flat rate, offering different service and pricing alternatives based on a combination of fixed (monthly) and variable (data transmission

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volume-based) rates. By the end of 2002 the number of subscribers using broadband access (T-DSL) was 2.8 million, compared to 1.3 million at the end of 2001.

Total revenues from non-access activities, such as advertising, increased by approximately EUR 146 million in 2002 and EUR 62 million in 2001, as compared with the previous years. The non-access revenues represented approximately 21.4% of total Internet services revenues for 2002. A substantial portion of total revenues from non-access activities is generated pursuant to a portal advertising agreement between T-Online International AG and Deutsche Telekom AG. Under that agreement, T-Online International AG provides Internet-based links to the Deutsche Telekom AG website. These inter-segment non-access revenues increased to EUR 103 million in 2002 from EUR 66 million in 2001 and EUR 31 million in 2000.

Revenues generated outside of Germany, mainly by our subsidiaries T-Online France and Ya.com, increased by EUR 44 million, or 46%, in 2002 as compared with 2001, and contributed to 8.8% of the total revenues generated by Internet services in 2002.

*Directory Advertising**Directory Advertising Revenues*

	For the year ended December 31,				
	2002	2001	2000	2002/01	2001/00
	(millions of euro)			(% change)	
Directory advertising	295	322	332	(8.4)%	(3.0)%
Other	24	26	35	(7.7)%	(25.7)%
<b>Total revenues from directory advertising</b>	<b>319</b>	<b>348</b>	<b>367</b>	<b>(8.3)%</b>	<b>(5.2)%</b>
Less intra- and inter-segment revenues	(38)	(36)	(42)	(5.6)%	14.3%
<b>Net revenues</b>	<b>281</b>	<b>312</b>	<b>325</b>	<b>(9.9)%</b>	<b>(4.0)%</b>

The T-Online division's directory advertising revenues come principally from the sale of advertising space in telephone and online directories. Revenues from marketing in other media is not currently material, although it is growing. The portion of the revenues that was generated by directory publication has decreased since October 2001.

The decrease in total revenues of EUR 28 million in 2002 compared with 2001 was in the amount of EUR 36 million a result of the sale of the DeTeMedien publishing house to TVG Verlag on October 1, 2001. This negative influence was partially offset by an increase in revenues of EUR 9 million from directory advertising primarily relating to the online directory.

Revenues decreased by EUR 19 million in 2001 compared with 2000. This development is attributable in particular to the sale of the DeTeMedien publishing house (EUR 9 million) and to the non-recurrence of income from marketing revenues relating to the equity offerings of Deutsche Telekom AG and T-Online (EUR 5 million) and revenue effects from transfer of the telephone card business to DeTeCard on October 1, 2001 (EUR 6 million).

***Income (Loss) before Taxes***

The T-Online division recorded income before taxes of approximately EUR 9 million in 2002, which was attributable primarily to increased revenues resulting from customer growth and improved product pricing. In addition, the division recorded a gain of EUR 27 million from the transfer of its 40% stake in T-Motion plc to T-Mobile International AG. Goods and services purchased as a percentage of revenue decreased in 2002, which contributed to positive income before taxes for 2002. This decrease in costs related mainly to the telecommunications services provided by Deutsche Telekom AG to T-Online International AG, and was caused mainly by the introduction of a new peak load pricing model in April 2002 and the complete abolition of T-Online's narrowband flat rate. However, losses relating to companies accounted for under the equity method of EUR 119 million, including a writedown of EUR 88 million against the carrying value of an investment in comdirect bank, adversely affected the 2002 results of the T-Online division.

The T-Online division recorded a loss before taxes of approximately EUR 233 million in 2001, reflecting losses relating to companies accounted for under the equity method of EUR 155 million, including a writedown of EUR 80 million against the carrying value of the investment in comdirect bank.

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The T-Online segment recorded income before taxes of EUR 2.6 billion in 2000, which included dilution gains of EUR 2.7 billion recognized by Deutsche Telekom AG relating to the issuance of T-Online International AG shares during the initial public offering of T-Online International AG, in addition to interest income on the invested cash proceeds received from the initial public offering. The operating results in 2000 were reduced by losses (including depreciation and amortization expenses) incurred in acquired companies (T-Online France and Ya.com), and increased personnel costs.

Income before taxes for the T-Online division reflects income from our directory advertising business of EUR 106 million in 2002, EUR 114 million in 2001 and EUR 114 million in 2000.

**Other Activities**

The following table presents selected financial information concerning our segment Other Activities.

	For the year ended December 31,				
	2002	2001 <sup>(1)</sup>	2000 <sup>(1)</sup>	2002/2001	2001/2000
	(millions of euro)			(% change)	
Net revenues	573	633	431	(9.5)%	46.9 %
Inter-segment revenues	3,838	4,481	4,770	(14.3)%	(6.1)%
Total revenues	4,411	5,114	5,201	(13.7)%	(1.7)%
Income (loss) before taxes	(4,454)	352	701	n.m.	(49.8)%

n.m. Not meaningful

(1) Segment information for 2001 and 2000 has been reclassified to conform to 2002 organizational changes among segments.

**Net Revenues**

Net revenues for the segment in 2002 were EUR 573 million, which represented a decrease of approximately EUR 60 million, as compared to 2001. This decrease is primarily attributable to the deconsolidation of revenues previously generated by Deutsche Telekom Gesellschaft fuer Satellitenkommunikation mbH (DeTeSat).

Net revenues from Other Activities amounted to EUR 633 million in 2001, representing an increase of EUR 202 million as compared to 2000. This increase was, among other reasons, a result of increased revenues from our real estate activities.

**Total Revenues**

Total revenues generated by the Other Activities segment as of December 31, 2002 totaled EUR 4,411 million compared to EUR 5,114 million at the close of 2001. This drop in total revenue of EUR 703 million is attributable in part to the spin-off of DeTeSat which accounted for approximately EUR 100 million. Also contributing to lower total revenues were cost efficiencies in Billing Services that were passed on to the divisions, resulting in a drop in revenues of approximately EUR 300 million for other activities. The remaining decrease in revenues stems from real estate services. There was a drop in demand for these services among the divisions. In addition, this segment handled fewer projects in 2002 than in the previous year.

Total revenues in 2001 amounted to EUR 5,114 million, representing a decrease of EUR 87 million, as compared to 2000. This decrease is primarily due to reduced revenues in Billing Services as cost efficiencies were passed on to other divisions.

*Income (Loss) before Taxes*

Income before taxes of Other Activities was significantly influenced in 2002, 2001 and 2000 by unusual or unscheduled factors. The segment generated a loss before taxes of EUR 4,454 million in 2002, as compared with income before taxes of 352 million in 2001. The significant factors contributing to this loss were a EUR 1,408 million increase in interest expense, largely attributable to loans for T-Mobile International AG (EUR 38 billion) that were converted from intergroup loans to equity.

Other factors contributing to the loss before taxes included losses relating to associated and related companies of EUR 718 million. These losses include a EUR 613 million writedown of the book value of the shares in France Telecom. The total revenues decline in the amount of EUR 703 million, of which EUR 643 million were related to inter-segment revenues, also contributed to the increase in the loss before taxes. In

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addition, 2002 expenses included approximately EUR 100 million of additional rent expense for real estate leases and approximately EUR 200 million of rebranding costs of the T-Mobile name. Further, EUR 200 million were recorded for provisions for doubtful accounts that relate mainly to the discount for credit risks from the sale of receivables in the T-COM asset backed securitization program. Offsetting these losses were EUR 500 million of gains mainly from the sale of Satelindo and a portion of the shares in T-Online.

The higher level of pre-tax earnings in 2001 compared with 2002 was attributable in part to gains from the sale of Sprint-FON and Sprint-PCS (EUR 1.9 billion). This amount includes expenses in the amount of EUR 0.1 billion related to this sale.

Other Activities income before taxes in 2000 was EUR 701 million, as compared with income before taxes of 352 million in 2001. The higher level of pre-tax earnings in 2000 compared with 2001 was attributable primarily to the higher gains on the sale of WIND (EUR 2.3 billion) compared to the sale of Sprint-FON and Sprint-PCS (EUR 1.9 billion) in 2001.

The establishment of the PSA as a central instrument for the socially responsible placement of staff within our group began in the fourth quarter of 2002. By December 31, 2002, approximately 1,700 employees had been placed in the PSA. Of these, approximately 150 are involved in the administration of the PSA. However, this has not yet affected the results of the Other Activities segment as it was established late in the year. The increase in employment compared to the previous year is also based on the creation of the PSA.

The PSA is expected to play a crucial role in the future. If it is possible to place surplus personnel who have been transferred to the PSA, this will have a positive effect on the further development of the group. Otherwise, this will have considerable negative effects on the segment Other Activities, which will partially offset the improvements in the divisions productivity in the group's results.

At December 31, 2002, Deutsche Telekom AG and the most relevant German real estate related subsidiaries (GMG Generalmietgesellschaft GmbH, DFMG Deutsche Funkturm GmbH and 1. Funkturm KG) had established reserves of EUR 685 million mainly for environmental issues, vacancy of properties, external leases, maintenance and construction and remediation obligations.

**LIQUIDITY AND CAPITAL RESOURCES**

The following table provides information regarding our cash flows.

	<b>For the year ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
	<b>(millions of euro)</b>		
Net cash provided by operating activities	12,463	11,934	10,000
Net cash used for investing activities	(10,040)	(5,365)	(27,706)
Net cash provided by (used for) financing activities	(3,435)	(4,811)	17,863
Effect of foreign exchange rate changes on cash and cash equivalents	(14)	(26)	(29)
Net increase (decrease) in cash and cash equivalents <sup>(1)</sup>	(1,026)	1,732	128
Cash and cash equivalents, at beginning of year	2,738	1,006	878
Cash and cash equivalents, at end of year	1,712	2,738	1,006

(1) Cash and cash equivalents include cash and short-term investments with original maturities of three months or less.

**Liquidity**

Generally, we manage the liquidity and capital resources for our consolidated group centrally. The tables included in this section present a summary of the significant financing and investing events and transactions that have affected our liquidity over the past three years.

*Net Cash Provided by Operating Activities*

Net cash provided by operating activities in 2002 amounted to EUR 12.5 billion. This represents an increase of EUR 0.5 billion, or 4.4%, as compared with 2001. This increase is attributable to an increase in cash received from certain derivatives used to hedge our interest rate exposures on debt and improvements in working capital, partially offset by increases in interest paid.



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Although our net loss increased by EUR 21.1 billion, from a net loss of EUR 3.5 billion in 2001 to a net loss of EUR 24.6 billion in 2002, our current year operating results were adversely affected by non-cash depreciation and amortization charges of EUR 36.9 billion, which were EUR 21.7 billion higher than in 2001. In addition, net results for 2002 include gains of EUR 0.5 billion from the sale of our investment in Satelindo and the sale of a portion of our interest in T-Online, as compared with the 2001 gains of EUR 1.9 billion from the sale of our interest in Sprint.

Net cash provided by operating activities in 2001 amounted to EUR 11.9 billion, representing an increase of EUR 1.9 billion, or 19.3%, as compared with 2000. Contributing to this increase was the receipt of a tax refund in 2001 and improvements in working capital, offset in part by increases in net interest paid.

Our net results declined to a net loss of EUR 3.5 billion in 2001 from net income of EUR 5.9 billion in 2000. The 2001 operating results were adversely affected by non-cash depreciation and amortization charges of EUR 15.2 billion, which were EUR 2.2 billion higher than in 2000. In addition, net results for 2001 include gains of EUR 1.9 billion from the sale of our interest in Sprint, as compared with gains in 2000 from the sale of our interest in Global One (EUR 2.9 billion) and from the sale of a majority of our ownership interest in our cable companies operating in North Rhine-Westphalia and Hesse (EUR 3.0 billion).

*Net Cash Used for Investing Activities*

Our net cash used for investing activities in 2002 amounted to EUR 10.0 billion, representing an increase of EUR 4.6 billion, or 87%, when compared with 2001. The increase in our cash usage was due in part to further cash investments in property, plant and equipment and consolidated companies. Specifically, our T-Systems division invested EUR 4.7 billion to acquire the minority interest in debis Systemhaus, and our T-Mobile division invested EUR 1.7 billion to acquire the remaining interest in Ben. In addition, our 2002 investing activities included lower proceeds from the disposals of short-term investments and marketable securities, offset in part by the proceeds received from sales of a portion of our real estate and sales of our trade receivables as part of the securitization program in our T-Systems division.

Our net cash used for investing activities in 2001 amounted to EUR 5.4 billion, representing a decrease of EUR 22.3 billion, or 80.6%, as compared with 2000. A substantial amount of this decrease results from the EUR 15.3 billion used in 2000 for the acquisition of intangible assets, primarily UMTS licenses, which was not repeated in 2001. In 2001 our T-Mobile division made cash outlays to acquire T-Mobile USA and Powertel. Also contributing to the reduction in our net cash used for investing activities were the cash proceeds received from the disposals of Sprint, FON and PCS (EUR 3.4 billion) and WIND (EUR 2.1 billion, net of withholding tax), and the proceeds received from sales of T-Com trade receivables in connection with its securitization program.

*Significant Investing Events*

Year Ended	Segment	Event	Amount
			(billions of euro)
2002	Other	Sales of real estate	1.3
2002	Other	Sale of shares in T-Online International AG to institutional investors	0.7
2002	T-Systems	Asset-backed securitization transaction	0.3
2002	Other	Sale of interest in Satelindo	0.3
2002	Other	Sale of interest in France Telecom	0.3
2002	T-Mobile	Exercise of call option to acquire 51% of Ben Nederland Holdings B.V.	(1.7)
2002	T-Systems	Acquisition of remaining 49.9% of T-Systems ITS GmbH (formerly debis Systemhaus)	(4.7)



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<b>Year Ended</b>	<b>Segment</b>	<b>Event</b>	<b>Amount</b>
			<b>(billions of euro)</b>
2001	Other	Sale of interests in Sprint, FON and PCS	3.4
2001	Other	Sale of interest in WIND (net of withholding tax)	2.1
2001	T-Com	Sale of receivables in an asset-backed securitization transaction	1.4
2001	T-Com	Sale of interest in regional cable television company for Baden-Wuerttemberg	0.9
2001	Other	Sale of real estate	0.7
2001	T-Com	Acquisition of interest in Macedonia Telecom (MakTel)	(0.3)
2001	T-Com	Acquisition of interest in Hrvatski Telecom (Croatia) <sup>(1)</sup>	(0.5)
2001	T-Mobile	Acquisition of interest in RadioMobil	(0.6)
2001	T-Mobile	Acquisition of T-Mobile USA and Powertel <sup>(1)</sup>	(5.1)

<b>Year Ended</b>	<b>Segment</b>	<b>Event</b>	<b>Amount</b>
			<b>(billions of euro)</b>
2000	T-Com	Sale of interest in the regional cable television companies for North Rhine-Westphalia and Hesse	3.0
2000	Other	Sale of interest in Global One	2.9
2000	Other	Sale of logistics center	0.4
2000	T-Com	Acquisition of interest in Slovak Telecom <sup>(1)</sup>	(1.0)
2000	T-Com	Acquisition of interest in Westel 900 (Media One)	(1.0)
2000	T-Mobile	Acquisition of interest in Ben Nederland Holdings BV	(1.1)
2000	T-Mobile	Acquisition of interest in PTC	(1.1)
2000	T-Com	Acquisition of interest in MATAV	(2.3)
2000	T-Mobile	Initial investment in T-Mobile USA	(5.6)
2000	T-Mobile	Acquisition of UMTS licenses in Germany, UK and Austria	(15.3)

(1) Represents gross amounts paid or received for entities acquired or sold excluding the effects of cash and cash equivalents held by the entity acquired or sold.

*Net Cash Provided by (Used for) Financing Activities*

Net cash used for financing activities amounted to EUR 3.4 billion in 2002. There were net cash inflows of EUR 11.7 billion from the increase in debt compared with EUR 13.9 billion in 2001. In May 2002, we issued EUR 2.5 billion principal 5-year bonds, EUR 2.0 billion principal 10-year bonds, and USD 0.5 billion (EUR 476 million) principal 30-year bonds. The issuances of this medium and long-term debt were used to refinance bank debt. The payment of dividends in respect of 2001 resulted in an outflow of cash and cash equivalents of EUR 1.6 billion as compared to EUR 1.9 billion in 2000.

Net cash used for financing activities in 2001 amounted to EUR 4.8 billion, as compared to net cash provided by financing activities of EUR 17.9 billion in 2000. This development resulted primarily from a net increase in medium and long-term liabilities in 2001. In 2000, cash flow provided by financing activities was significantly influenced by the proceeds from the issuance of multi-currency global bonds in an aggregate amount equivalent to approximately EUR 15.4 billion at that point in time, the proceeds of which were applied primarily to refinance short term indebtedness incurred to finance the acquisition of UMTS licenses. In 2001, we issued EUR 4.5 billion principal 5-year bonds, EUR 3.5 billion principal 10-year bonds, and JPY 160 billion (EUR 1.4 billion) principal 3 to 7-year bonds. New indebtedness incurred during 2001 was used primarily to refinance maturing bonds. Net cash provided by financing activities in 2000 included the proceeds of the initial public offering of T-Online (EUR 3.1 billion) with no equivalent proceeds from similar transactions in 2001. Dividends paid in 2001 remained unchanged from the amounts paid in 2000.



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<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u>
			(billions of euro)
2002	Other	Net repayments of short-term debt	(10.0)
2002	Other	Issuances of medium and long-term debt	11.7
2002	Other	Repayments of medium and long-term debt	(3.5)
2002	Other	Payment of dividends to Deutsche Telekom AG Shareholders	(1.6)
			(billions of euro)
2001	Other	Net repayments of short-term debt	(10.3)
2001	Other	Issuances of medium and long-term debt	13.9
2001	Other	Repayments of medium and long-term debt	(6.6)
2001	Other	Payment of dividends to Deutsche Telekom AG Shareholders	(1.9)
			(billions of euro)
2000	Other	Net repayments of short-term debt	(0.8)
2000	Other	Issuances of medium and long-term debt	19.7
2000	Other	Repayments of medium and long-term debt	(2.4)
2000	Other	Payment of dividends to Deutsche Telekom AG Shareholders	(1.9)
2000	T-Online	Initial Public Offering of shares in T-Online International AG	3.1

**Capital Resources**

The following table summarizes our financial indebtedness at December 31, 2002:

**Payments Due by Period**

	<u>Total</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>thereafter</u>
							(millions of euro)
Bonds and debentures	56,752	8,535	12,320	8,392	4,921	3,610	18,974
Liabilities to banks	6,292	1,341	557	2,582	161	234	1,417
<b>Total</b>	<b>63,044</b>	<b>9,876</b>	<b>12,877</b>	<b>10,974</b>	<b>5,082</b>	<b>3,844</b>	<b>20,391</b>

At December 31, 2002, the Federal Republic guaranteed EUR 14.5 billion of our liabilities. For further details see Item 7. Major Shareholders and Related Party Transactions. For a discussion of funding and treasury policies, see note (29) to our consolidated financial statements and Item 11. Quantitative and Qualitative

Disclosures About Market Risk.

Our debt position at December 31, 2002, decreased from the 2001 year-end level of EUR 67.0 billion to EUR 63.0 billion. For 2003, we have set as a key objective the continued reduction of our debt position to support our credit standing, address investor concerns about our debt burden and enhance our long-range flexibility and growth.

In 2002, we decreased our debt position through a combination of factors. Among the major contributors were cash generated from operations (EUR 12.5 billion), real estate disposals (EUR 1.3 billion), the sale of minority shareholdings (EUR 0.6 billion), the sale of shares in T-Online International AG (EUR 0.7 billion) and the sale of receivables under the T-Systems International asset-backed-securitization program (EUR 0.3 billion). These cash flows were partially offset by cash used to purchase the remaining interests in debis Systemhaus (EUR 4.7 billion) and the Dutch mobile telecommunications carrier Ben (EUR 1.7 billion purchase price and EUR 0.3 consolidation of debt) and for the payment of dividends (EUR 1.6 billion). Our debt position was also affected by changes in balance sheet working capital values, in addition to a positive effect of changes in foreign currency exchange rates (EUR 2.4 billion) principally related to the weakening of the U.S. dollar against the euro.

We employ a variety of financing sources to fund our operations and liquidity needs. The principal financial instruments we use are bonds, medium-term notes and commercial paper issued in various jurisdictions and in various currencies. Further sources of liquidity are committed credit facilities, consisting

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of bilateral credit agreements and syndicated loans. Please refer to note (29) to our consolidated financial statements for a discussion of our most significant debt offerings during 2002.

***Interest Step-Up Provisions and Credit Ratings***

In March 2002, Moody's lowered its rating of our senior unsecured debt from A3 to Baa1, and further downgraded its rating to Baa3 in January 2003. In April 2002, Standard & Poor's lowered its rating of our senior unsecured debt from A- to BBB+. The changes in 2002 triggered a step-up of 50 basis points with effect from the first interest payment dates after April 2002 for future interest payments on approximately EUR 23.6 billion of outstanding Deutsche Telekom bonds denominated in various currencies. We estimate that this step-up will result in an increase in our interest expense on these bonds of approximately EUR 118 million per annum.

In May 2002, we issued bonds with aggregate principal amounts EUR 4.5 billion and USD 0.5 billion. These bonds were issued in three tranches: two euro-denominated tranches—a EUR 2.5 billion principal tranche with a 5-year maturity and a EUR 2.0 billion principal tranche with a 10-year maturity—and a US\$ 0.5 billion principal tranche with a 30-year maturity. These bonds also contain step-up provisions that would result in a 50 basis point increase in interest rates in the event of a lowering of our senior unsecured debt ratings below Baa1 by Moody's and BBB+ by Standard & Poor's. Further, an event causing an interest step-up for these bonds also would trigger a 50 basis point step-up for the interest on EUR 2.2 billion in medium-term notes we issued in 2002 in different currencies and EUR 2.4 billion we issued from January 2003 to April 7, 2003 in different currencies. With regard to Moody's downgrade of our senior unsecured debt rating to Baa3 in January 2003, we will be subject to these interest rate step-ups if Standard & Poor's reduces our debt rating below BBB+. We estimate that such a step-up would result in an increase in our interest expense on these bonds and notes of approximately EUR 47.6 million per annum.

***Lines of Credit***

At December 31, 2002, we and our subsidiaries had committed credit facilities with banks totaling approximately EUR 22.2 billion, as well as credit facilities on demand of EUR 0.4 billion. The credit facilities include two syndicated loan facilities: one having Deutsche Telekom AG and its Dutch finance subsidiary, Deutsche Telekom International Finance B.V. as borrowers (the DT loan facility), in the aggregate amount of EUR 12.0 billion, and one having T-Mobile UK as borrower (the T-Mobile UK loan facility) in the aggregate amount of GBP 2.8 billion (EUR 4.2 billion). At December 31, 2002, there were no outstanding borrowings under the DT loan facility but we had EUR 1.5 billion of outstanding commercial paper which reduces our capability to draw borrowings under Tranche A of the DT loan facility. Tranche A of DT loan facility serves as a back-up for our commercial paper program. Under the T-Mobile UK loan facility were GBP 1.3 billion (EUR 2.0 billion) outstanding at December 31, 2002.

The tranches available under the DT loan facility expire at the following dates and in the following principal amounts:

<b>Tranche name</b>	<b>Maximum amount</b>	<b>Maturity date</b>
Tranche A	EUR 5.0 billion	September 29, 2003
Tranche B	EUR 3.0 billion	October 1, 2003
Tranche C	EUR 2.0 billion	October 1, 2005
Tranche D	EUR 2.0 billion	October 1, 2007

Tranches available under the T-Mobile UK loan facility expire at the following dates and in the following principal amounts:

<b>Tranche name</b>	<b>Maximum amount</b>	<b>Maturity date</b>
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Tranche B	GBP 1.8 billion	October 1, 2005
Tranche C	GBP 1.0 billion	October 1, 2007

Due to the downgrade of our credit ratings in March 2002 and April 2002, the commitment fee payable under the syndicated loan facilities increased by approximately 2.5 basis points on undrawn amounts per annum, and the interest rate expense on outstanding borrowings increased by 7.5 basis points. Further downgrades will not effect these conditions.

Also included in our group's credit facilities are committed lines of credit through multiple bilateral unsecured credit agreements with various banks which are usually on a revolving basis. At December 31,



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2002, we had committed lines of credit through these agreements totaling EUR 6.0 billion. The interest and commitment fees payable on these facilities are based upon the terms of each specific contract. Approximately EUR 1.5 billion in aggregate principal amount was outstanding under these agreements at December 31, 2002.

Our bank loan agreements contain customary provisions relating to defaults and material adverse changes affecting Deutsche Telekom AG and/or the relevant borrower. As a result of these provisions, the non-payment of a significant amount of debt when due or the acceleration of due dates can result in all or part of our bank debt becoming due or make our committed lines of credit unavailable. Our syndicated loan facilities and, at December 31, 2002, EUR 1.0 billion of our bilateral credit agreements each contain a financial covenant that requires us to maintain a ratio of EBITDA to net interest payable, each as defined therein, of 3:1, tested for each twelve month period ending in June and December of each year. EBITDA as defined for purposes of these covenants does not make reference to special effects and is calculated with reference to net interest payable, rather than to net financial income (expense). At December 31, 2002, we were in full compliance with these covenants. The covenants in our bank loan agreements also set conditions for permitted security interests, disposals and certain types of additional borrowings and guarantees. We do not expect that these negative covenants will materially affect our debt reduction plans or our ability to raise capital as needed.

**Capital Requirements**

Our funding sources for 2003 consists primarily of cash flows from operations, proceeds from the sale of interests in certain subsidiaries and affiliates, proceeds from the sale or other monetization of other assets (including real estate) and through external financing in the debt market. We cannot, however, offer assurances that we will be able to meet all our cash flow and deleveraging objectives. For further information concerning risks associated with our liquidity management, see Item 3. Key Information Risk Factors.

**Capital Expenditures and Investments**

The following table provides information concerning capital expenditures and investments in subsidiaries, associated companies and related companies as well as proceeds from the sales of non-current assets and investments.

	For the year ended December 31,				
	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
Capital expenditures	7,625	10,868	23,536	(29.8)%	(53.8)%
Investments	6,973	6,193	12,830	12.6%	(51.7)%
Proceeds from sales of non-current assets and investments	(3,145)	(5,872)	(8,253)	46.4%	28.9%
Other	(1,413)	(5,824)	407	14.2%	n.m
<b>Net cash used for investing activities</b>	<b>10,040</b>	<b>5,365</b>	<b>27,706</b>	<b>4.7%</b>	<b>(65.1)%</b>

n.m. not meaningful

**Capital Expenditures**

The following table provides information about our capital expenditures for the years presented. Other capital expenditures include advanced payments and construction in progress, as well as plant and office equipment.

## For the year ended December 31,

	2002	2001	2000	2002/2001	2001/2000
	(millions of euro)			(% change)	
Intangible assets (excluding goodwill)	873	1,376	15,980	(36.6)%	(91.4)%
Fixed networks	2,609	3,831	2,985	(31.9)%	28.3%
Mobile networks	826	1,692	873	(51.2)%	93.8%
Buildings	177	159	263	11.3%	(39.5)%
Other capital expenditures	3,150	3,810	3,435	(17.3)%	10.9%
<b>Total capital expenditures</b>	<b>7,625</b>	<b>10,868</b>	<b>23,536</b>	<b>(29.8)%</b>	<b>(53.8)%</b>

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The reduction in total capital expenditures in 2002 compared to 2001 reflects the reduction in our capital spending as networks have been completed and reductions made to reduce cash outflows.

Other capital expenditures included advanced payments and construction in progress that are mainly related to T-Mobile. Capital expenditures in 2001 decreased compared to 2000, mainly attributable to the payment for the acquisition of UMTS licenses in Germany, the United Kingdom and Austria (EUR 15.3 billion) and to the investments in work in progress for mobile networks (EUR 1.2 billion).

For 2003, we expect to invest between EUR 6.7 and 7.7 billion in intangible assets (excluding goodwill) and property, plant and equipment. The precise amount for our capital expenditures will depend in part on the development of our cash flows in 2003. We are focusing our investments on business activities that we believe have the greatest capital expenditure needs and the best potential for rewarding growth. Accordingly, we expect to make the largest portion of our planned investments in our T-Com and T-Mobile divisions. We are emphasizing the extension of transmission capacity and the T-DSL business, as well as the build-out of our UMTS services in Europe and our networks in the United States. We plan to invest approximately one half of the capital expenditures budget in Germany and the other half outside Germany. We plan to finance this investment through a variety of sources, including cash flows from operations, proceeds from the sale of assets (including real estate) and through external financing in the debt markets.

***Investments***

Investments in subsidiaries, associated companies and other financial assets amounted to EUR 7.0 billion in 2002. Investments in fully consolidated companies, which accounted for EUR 6.4 billion, related to the full acquisition of debis Systemhaus (EUR 4.7 billion) and the purchase of Ben Nederland Holding B.V. (EUR 1.7 billion). Investments in associated and related companies and other financial assets amounted to EUR 0.6 billion and related primarily to the joint venture Bild.t-online.de and GSM Facilities.

Investments in subsidiaries, associated companies and other financial assets amounted to EUR 6.2 billion in 2001. Investments in fully consolidated companies, which accounted for EUR 5.7 billion, related primarily to T-Mobile USA and Powertel, RadioMobil, Hrvatski Telecom and MATAV. Investments in associated and related companies and other financial assets, amounted to EUR 0.5 billion.

Investments in subsidiaries, associated companies and other financial assets amounted to EUR 12.8 billion in 2000. Investments in fully consolidated companies, which account for EUR 4.3 billion, related primarily to MATAV, Westel 900 and Slovak Telecom. Investments in associated and related companies and other financial assets, which accounted for EUR 8.5 billion, related primarily to the initial investments in T-Mobile USA, PTC and Ben.

**Contractual Obligations and Other Commitments**

At December 31, 2002, we had contractual cash obligations for accruals totaling EUR 16.1 billion and liabilities totaling EUR 73.6 billion. In addition, we have other financial obligations for payments to special pension funds, purchase commitments, commitments arising from transactions not yet settled and operating leases.

***Financial Indebtedness***

The following table summarizes financial indebtedness recorded in our balance sheet under liabilities as of December 31, 2002:

**Payments Due by Period**

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	<u>Total</u>	<u>Less than 1 Year</u>	<u>1-5 Years</u>	<u>After 5 Years</u>
(millions of euro)				
<b>Financial Indebtedness</b>				
Bonds and debentures	56,752	8,535	29,243	18,974
Liabilities to banks	6,292	1,341	3,534	1,417
Debt	<u>63,044</u>	<u>9,876</u>	<u>32,777</u>	<u>20,391</u>
Capital lease obligations	<u>543</u>	<u>50</u>	<u>215</u>	<u>278</u>

For more information regarding our indebtedness refer to [Liquidity and Capital Resources](#) [Capital Resources](#) and note (29) to the consolidated financial statements.

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At December 31, 2002, the present value of capital lease obligations amounted to EUR 543 million, primarily for office buildings with varying terms of up to 25 years. The undiscounted value of the obligation was EUR 965 million.

**Other Financial Obligations**

Other financial obligations at December 31, 2002, consisted of the following:

	<b>Payments Due by Period</b>		
	<b>Total</b>	<b>Less than 1 Year</b>	<b>After 1 Year</b>
	(millions of euro)		
Present value of payments to special pension fund	9,001	831	8,170
Purchase commitments for interest in other companies	826	218	608
Purchase commitments for capital projects in progress, including obligations arising from future expenditures	1,213	1,141	72
Commitments arising from transactions not yet settled	475	364	111
Operating leases	10,050	1,813	8,237
<b>Total other financial obligations</b>	<b>21,565</b>	<b>4,367</b>	<b>17,198</b>

In accordance with Postreform II, we are required to make payments to our special pension fund for civil servants or its successor. The amounts currently due in each period are recognized as an expense in that period. The present value of such payments calculated using certain life expectancy tables as a basis amounted to EUR 9.0 billion at December 31, 2002, of which EUR 3.8 billion relates to future years of service of the active civil servant staff.

Purchase commitments for interests in other companies are mainly those of purchase commitments of Deutsche Telekom AG (EUR 490 million). Furthermore, T-Mobile has served notice to exercise its right to acquire additional shares in PTC (EUR 128 million). This exercise is currently the subject of an arbitration proceeding. For more information, refer to Item 8. Financial Information Litigation Securities and Corporate Law-related Proceedings. In addition, T-Online and T-Mobile have obligations to invest an additional EUR 90 million and EUR 70 million, respectively, in various venture funds.

Purchase commitments for capital projects in progress including obligations arising from future expenditures, include commitments by each of Deutsche Telekom AG (EUR 567 million), T-Mobile (EUR 413 million) and T-Systems (EUR 139 million) for capital projects.

During 2002, we sold real estate to a newly established real estate fund for EUR 525 million. In connection with the sale, we have committed to lease back the real estate sold for a period of 15 years. We have a call right to acquire all the shares of the real estate fund after 10 years and the shareholders of the fund have a put right to compel us to acquire all the shares of the real estate fund after 16 years. The call and put prices are based on formulas, determined on the then cash flow multiples generated by the transferred real estate, and adjusted for outstanding mortgage loans at the time of exercise. Based on current market conditions, the undiscounted future put price would be approximately EUR 420 million, net of mortgage loans assumed of approximately EUR 210 million.

Commitments arising from transactions not yet settled concern pending transactions that are open at the balance sheet date. Primarily, T-Mobile Deutschland has commitments from pending transactions (EUR 354 million). These commitments include stipulated purchase quantities that are not exercised at the balance sheet date, for example the obligation to accept UMTS and 3G equipment or network equipment from Siemens, Nokia and Nortel.

At December 31, 2002, we had a total of EUR 10.0 billion in total future payment obligations under non-cancelable operating leases over varying terms of up to 25 years.

**Table of Contents*****Guarantees and commitments***

The following table summarizes liabilities arising from warranty agreements and guarantees as of December 31, 2002:

	Amount of Commitment expiration by Period		
	Total	Less than 1 Year	After one year
	(millions of euro )		
Liabilities arising from warranty agreements	927		927
Guarantees	47		47
<b>Total</b>	<b>974</b>		<b>974</b>

Liabilities arising from warranty agreements represent an implicit guarantee in case of the breach of certain provisions of contractual obligations. In March 2002, T-Mobile Deutschland entered into lease financing arrangements whereby certain equipment, mainly GSM infrastructure and software, was leased to several U.S.-based trusts and leased back to T-Mobile Deutschland. Concurrent with entering into these lease arrangements, T-Mobile Deutschland entered into payment undertaking agreements with two counter-parties, whereby the counter-parties agreed to make certain payments to the U.S. trusts on behalf of T-Mobile Deutschland in exchange for an irrevocable payment of EUR 909 million equal to the scheduled rent payable by T-Mobile Deutschland and, if fixed price purchase options in the lease backs are exercised, the exercise prices of these options.

Guarantees principally represent the commitment to pay unconditionally and irrevocably with primary responsibility any outstanding amount owed by another party. Generally, we issue guarantees in respect of leasing and loan agreements. Further information about these guarantees is included in note (29) to the consolidated financial statements.

We are a partner in a consortium that has contracted with the Federal Republic of Germany to develop and operate, through a separate operating joint venture company (the project company), a toll collection system for the use by certain commercial vehicles of roadways in Germany. Pursuant to this arrangement, we have, along with our partners, Daimler Chrysler Services AG and Cofiroute S.A., guaranteed, on a joint and several basis through the first year of approved operation of the toll collection system, the successful completion and operation of the toll collection system. In the event that the toll collection system is not completed on schedule, or does not operate effectively upon completion, the amount of revenues to be received by the project company pursuant to this arrangement may be significantly reduced, and in the first year, the project company or the consortium, and thereafter only the project company, may be subject to significant penalties as well (not to exceed an aggregate of EUR 150 million during the first year of operation and EUR 100 million per year thereafter). Further, there are no restrictions on the ability of the Federal Republic to recover damages, and we are also obligated, on a joint and several basis, to continue to fund the losses of the project company, including losses as a result of penalties and damages, through the term of this arrangement.

***Other Contingent Obligations***

In July 2000, we acquired a 51% equity interest in the state-owned Slovak Telecom, the leading full-service telecommunications service provider in Slovakia, for a purchase price of EUR 1 billion. Slovak Telecom offers local, long-distance and international telephone services, data communications services, telex and telegraph services, distribution and broadcast radio and television signals and mobile communications services via its majority-owned subsidiary, Eurotel. Pursuant to a Shareholders' Agreement with the Slovak Republic, we are

obligated to make certain additional capital investments in Slovak Telecom (currently up to EUR 1 billion by December 31, 2003, of which EUR 572 million has already been invested in Slovak Telecom and Eurotel). We will continue to make investments in accordance with telecommunications development requirements and taking into account economic growth patterns in the Slovak Republic. The nature and amount of additional investments in 2003 and our overall investment commitment is currently under discussion with representatives from the Slovak Government pursuant to the terms of the Shareholders' Agreement.

On May 3, 1999, Western Wireless Corporation (referred to herein as Western Wireless), distributed its entire 80.1% interest in T-Mobile USA's (formerly VoiceStream) common shares to its stockholders. Prior to this spin-off, Western Wireless obtained a favorable ruling from the IRS indicating that the spin-off would



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not result in the recognition of a gain or taxable income to Western Wireless or its stockholders. However, Western Wireless could still recognize a gain upon the spin-off, notwithstanding the favorable IRS ruling, if it is determined that the spin-off was part of a prohibited plan, that is, a plan or series of related transactions in which one or more persons acquire, directly or indirectly, 50% or more of T-Mobile USA's stock. Acquisitions of 50% or more of T-Mobile USA's stock occurring during the four-year period beginning two years before the spin-off could give rise to a rebuttable presumption that the spin-off was part of a prohibited plan. Although it is not assured, T-Mobile USA believes that the spin-off, subsequent mergers, including the T-Mobile merger in 2001, and certain investments by Hutchison Telecommunications PCS (USA) Limited and Sonera Corporation in 2000 were not pursuant to a prohibited plan. T-Mobile USA has agreed to indemnify Western Wireless on an after-tax basis for any taxes, penalties, interest and various other expenses incurred by Western Wireless if it is required to recognize such a gain. The amount of such gain that Western Wireless would recognize would be equal to the difference between the fair market value of T-Mobile USA common shares at the time of the spin-off and Western Wireless' adjusted tax basis in such shares at the time. The estimated range of possible liability, not including interest and penalties, if any, is from zero to \$400 million.

**CRITICAL ACCOUNTING POLICIES UNDER U.S. GAAP**

The reconciliation of our consolidated financial statements from German GAAP to U.S. GAAP is dependent upon accounting methods, assumptions and estimates that we use as a basis for the preparation of our financial statement amounts under U.S. GAAP. We have identified the following critical accounting policies and related assumptions, estimates and uncertainties, which we believe are essential to understanding the underlying financial reporting risks and the impact that these accounting methods, assumptions, estimates and uncertainties have on our reconciled U.S. GAAP financial statement amounts.

**Recovery of Long-Lived Assets*****Goodwill and Intangible Assets with Indefinite Lives***

At December 31, 2002, our long-lived intangible assets amounted to EUR 61,567 million. We adopted the provisions of SFAS 142, Goodwill and Other Intangible Assets, as of January 1, 2002, which did not result in any impairment as of that date. SFAS 142 requires that goodwill and other indefinite lived intangible assets be tested for impairment at least annually using a two-step approach at the reporting unit level. In the first step, the fair value of the reporting unit is compared to its book value, including goodwill and intangible assets. The determination of fair value of each reporting unit, which requires significant judgment, is generally based on the present value of future cash flows. In the case that the fair value of the reporting unit is less than its book value, a second step is performed, which compares the fair values to the book values of the reporting units' goodwill and intangible assets. The fair value of goodwill is determined based upon the differences between the fair value of the reporting unit and the net of the fair values of the identifiable assets and liabilities of the reporting unit. The fair value of indefinite lived intangible assets is determined based on expected discounted future cash flows. If the fair value of goodwill and other indefinite lived intangible assets are less than their book values, the differences are recorded as impairment charges. We performed our annual impairment review in respect of the quarter ended September 30, 2002, and we recorded impairment charges of EUR 14,567 million and EUR 9,923 million relating to goodwill and other indefinite lived intangible assets as a result of these impairment tests.

***Property, Plant and Equipment, and Amortizable Intangible Assets***

We review long-lived assets, including property, plant and equipment and amortizing intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets that are held and used is measured by comparing the sum of the future undiscounted cash flows derived from an asset (or a group of assets) to their carrying value. If the carrying value of the asset (or the group of assets) exceeds the sum of the future undiscounted cash flows, impairment is considered to exist. If an impairment is considered to exist on the basis of undiscounted cash flows, the impairment charge is measured using an estimation of the assets' fair value, typically using a discounted cash flow method. The identification of impairment indicators, the estimation of future cash flows and the determination of fair values for assets (or groups of assets) requires management to make significant judgments concerning the identification and validation of impairment indicators, expected cash flows and applicable discount rates. Specifically, the estimation of cash flows underlying the fair values of our mobile businesses consider the continued investment in network infrastructure required to generate future revenue



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growth through the offering of new data products and services, for which we have limited historical information on customer demand. If the demand for these products and services does not materialize as we expect, we will generate less revenue and cash flows and potential impairment charges to writedown these investments to net realizable value, which could adversely affect our future operating results.

A continuation of the currently depressed economic conditions in the telecommunications industry within Europe and the United States could result in an increasingly competitive pricing environment due to significant industry over-capacity. Furthermore, weakness in the T-Mobile and T-Systems segments could result in diminished values of recently acquired technologies and licenses or goodwill. Such events could result in reductions of the future estimates of net cash flows to be generated to the extent that both long-lived tangible and intangible assets could be considered impaired, adversely affecting our future operating results.

### ***Recovery of Long-Term Investments***

We have made investments in foreign telecommunications service providers that are principally engaged in the mobile, fixed line, Internet and data communications businesses. We also have equity and debt investments that we received as sales consideration in disposals of certain cable and other businesses. At December 31, 2002, the carrying value of our long-term investments was EUR 4,169 million. The most significant investments are PTC in which we own a 49% interest, MTS in which we own a 36.2% interest, and GSM Facilities in which we own a 25.6% interest.

Of the total carrying value of our financial assets at December 31, 2002, EUR 752 million represent shares in publicly traded companies that are classified as available-for-sale and reflected in the balance sheet at fair value. Changes in the fair value are reported in a separate component of shareholders' equity. For the remaining investments in financial assets, our accounting policy is to record an impairment of such investments to net realizable value when the decline in fair value below carrying value is deemed to be other than temporary. To the extent that these investments are not publicly traded, fair value is determined based on judgments and estimates of expected future cash flows. In determining if a decline in value is other than temporary, we consider factors such as the length of time and magnitude of the excess of carrying value over market value, the forecasted results of the investee, the regional geographic economic environment and state of the industry, and our ability and intent to hold the investment.

A prolonged downturn in the telecommunications industry could negatively affect the operations of these investments and their ability to generate future cash flows. This could result in changes to the forecasted cash flows and potential impairment charges, which could adversely affect our future operating results.

## **Revenue Recognition**

### ***Customer Activation Fees***

Our T-Com and T-Mobile divisions receive certain installation and activation revenues from new customers. We defer the recognition of these revenues (and related costs) and amortize them over the expected duration of the customer relationship. The estimation of the expected average duration of the relationship is based on historical customer turn-over. If management's estimates are revised, material differences may result in the amount and timing of Deutsche Telekom's revenue for any period.

### ***Long-Term Service Contracts***

Our T-Systems division conducts a significant portion of its business under long-term contracts with customers. We account for certain long-term service contracts using the percentage-of-completion method, recognizing revenue as performance on a contract progresses. This method places considerable importance on accurate estimates of the extent of progress towards completion. Depending on the methodology used to determine contract progress, the significant estimates may include total contract costs, remaining costs to completion, total contract revenues, contract risks and other judgments. We regularly review all estimates involved in such long-term contracts and adjust them as necessary.

**Deferred Taxes**

At December 31, 2002, total net deferred tax assets were EUR 336 million. Included in this total are the tax benefits of net operating losses of approximately EUR 8,354 million. These tax loss carryforwards generally do not expire under current German law, except certain amounts attributable to non-German operations, which expire between 2008 and 2022.

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We have recorded a valuation allowance to reduce the deferred tax assets to an amount that we believe is more likely than not to be realized. In assessing the need for the valuation allowance, we considered future taxable income and ongoing prudent and feasible tax planning strategies. In the event that our estimates of projected future taxable income and benefits from available tax strategies are lowered, or changes in current tax regulations are enacted that would impose restrictions on the timing or extent of our ability to utilize the tax benefits of net operating loss carryforwards in the future, an adjustment to the recorded amount of net deferred tax assets would be made, with a related charge to income.

**Pension Accounting**

Our pension obligations for benefits to non-civil servants are generally satisfied by defined benefit plans. Our pension benefit costs for non-civil servants are determined in accordance with actuarial assumptions, which rely on assumptions including discount rates, life expectancies, and to a limited extent, expected return on plan assets. Estimations of the expected return on plan assets have a limited impact on our pension cost since the amount of funded plan assets are small in relation to our outstanding pension obligation. Other key assumptions for our pension costs are based in part on actuarial valuations, which rely on assumptions, including discount rates used to calculate the amount of our pension obligation. Due to the underfunded status of certain pension plans at their respective measurement dates, a charge, representing the additional minimum liability is recorded net of a related deferred tax benefit in other comprehensive income. During 2002, we recorded an increase of approximately EUR 220 million to our additional minimum pension liability. This increase was mainly attributable to a decrease of the discount rate used in the calculation of our pension liability from 6.00% in 2001 to 5.75% in 2002. In addition, plan assets increased slightly from EUR 405 million at December 31, 2001 to approximately EUR 410 million at December 31, 2002. Our assumptions concerning the expected return on plan assets are determined on a uniform basis, considering long-term historical returns, asset allocation, and future estimates of long-term investment returns. In the event that further changes in assumptions are required with respect to discount rates and expected returns on invested assets, the future amounts of our pension benefit costs may be affected materially.

Our pension plan obligations with respect to civil servant employees and retirees are subject to a special regime that effectively fixes our annual costs at 33% of the pensionable gross remuneration of active civil servants and the notional pensionable gross remuneration of civil servants on leave of absence. The funding of this annual contribution is recognized as a period expense. In accordance with both U.S. and German GAAP, no liability or accrual has been recorded in respect of future payments.

For further information concerning our pension plan arrangements for civil servants and non-civil servants, please refer to note (27) to our consolidated financial statements and Item 6. Directors, Senior Management and Employees Employees and Labor Relations.

**Civil Service Health Insurance Fund**

We are obligated, under Postreform II, to pay for any operating cost shortfalls between the sources of regular income of the Civil Service Health Insurance Fund (*Postbeamtenkrankenkasse*, PBeaKK) and benefits paid. The PBeaKK provides healthcare and medical benefits for its members and their relatives, who are civil servants employed by or retired from Deutsche Telekom AG, Deutsche Post AG and Deutsche Postbank AG. When Postreform II came into effect, the PBeaKK was closed to new members. The insurance premium collected by the PBeaKK may only be increased by the amount by which healthcare costs in Germany rise on average and therefore does not reflect the changing age structure of the PBeaKK. We have accrued the actuarially determined present value of the fund's future deficit which we have to cover using a discount rate, assumptions about life expectancy and projections for contributions and future increases in general health care costs. Because the calculation of this accrual involves long-term projections over periods of more than 50 years, the present value of the liability is sensitive to small variations in the assumptions used for the calculation.

**Other Accruals**

We record an accrual for liabilities when a loss contingency is considered to exist and when a loss is considered probable and can be reasonably estimated. Significant estimates are involved in the determination of

provisions related to taxes, environmental liabilities and litigation claims. These estimates are subject to change as new information becomes available to us, primarily with the support of internal specialists, if available, or with the support of outside consultants, such as actuaries or legal counsel. Revisions to our estimates of these loss contingencies may significantly affect future operating results.

**Table of Contents****RECONCILING DIFFERENCES BETWEEN GERMAN GAAP AND U.S. GAAP**

Our results are reported under German GAAP and differ from our results when reconciled to U.S. GAAP, as summarized below. A more detailed discussion and quantification of significant differences between German GAAP and U.S. GAAP applicable to our consolidated financial statements may be found in notes (40) through (43) to our consolidated financial statements contained in this Annual Report. The differences between German GAAP and U.S. GAAP that have a significant impact on net income (loss) and shareholders' equity are summarized below. Other differences may arise in future years, resulting from new transactions and/or the adoption of new accounting standards.

**Differences in Bases of Long-Lived Assets***Adjustments to Valuation of Fixed Assets*

Under German GAAP, we previously recorded nonscheduled depreciation of fixed assets primarily relating to our real estate holdings. This nonscheduled depreciation was not required under U.S. GAAP for real estate classified as held and used. This results in a difference in the carrying basis of land and buildings between U.S. GAAP and German GAAP. This basis difference results in higher depreciation expense to be recorded under U.S. GAAP than under German GAAP. In addition, these basis differences will affect the gains or losses to be recognized upon sale of real estate, to the extent these differences in carrying values relate to assets sold.

*Real Estate Sale and Leaseback*

We entered into a series of sale and leaseback transactions with respect to certain of our real estate holdings. These leasebacks generally qualify as off-balance sheet operating leases under German GAAP. However, these transactions have been accounted for as financings under U.S. GAAP due to our continuing involvement. This results in interest expense and the continuation of depreciation expense for U.S. GAAP, as compared with gains/losses on sales of real estate and rent expense for German GAAP.

*Differences in Valuations of Goodwill and Other Assets*

The differences between German GAAP and U.S. GAAP in the determination of total purchase consideration in purchase business combinations has resulted in differences in the initial valuation of goodwill and other intangible and tangible assets. Purchase price differences between German and U.S. GAAP have been generated from business combinations due to net assets acquired, valuation of shares and stock options issued (including subsidiary shares issued in a business combination), valuation of underlying assets and liabilities (including deferred taxes), dates used to calculate consideration paid as well as the date at which an acquisition is considered consummated. These differences have resulted in differences in amounts for depreciation and amortization expenses. In 2002, the U.S. GAAP accounting for goodwill and indefinite lived intangible assets changed, resulting in these intangibles no longer being amortized, but rather subject to an annual impairment test. During the third quarter of 2002, we completed the annual impairment test, resulting in writedowns of goodwill and indefinite lived intangible assets under U.S. GAAP in amounts different than those determined under German GAAP.

*Valuation of Trade Names*

Under German GAAP, we previously recorded a nonscheduled amortization of intangible assets relating to the rebranding of the trade names of acquired subsidiaries to a T-Mobile brand name. This write-off was not recorded for U.S. GAAP purposes, as it did not meet the U.S. GAAP impairment criteria. However, the remaining useful lives were shortened, and the remaining carrying amount was completely amortized during the current year.

*Capitalization and Amortization of Mobile Communication Licenses*

Under German GAAP, we begin to amortize our communication licenses, primarily European UMTS licenses and U.S. mobile communications licenses, upon acquisition and continue to amortize these licenses

through their expected period of use. Under U.S. GAAP, amortization begins at the time the network is placed into service. In addition, interest on mobile network construction related to debt is expensed under German GAAP, whereas under U.S. GAAP this interest is capitalized during the period the mobile network is being constructed, and is subsequently amortized over the expected period of use. This results in deferrals of interest and amortization expenses for U.S. GAAP, and a higher carrying basis of our mobile network fixed



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assets. Once the networks are in place, capitalization of these costs will cease and related costs capitalized will be amortized into income over the remaining expected period of use. The completion of our annual impairment test with respect to the third quarter resulted in nonscheduled amortization of mobile communication licenses under U.S. GAAP in amounts different than those determined under German GAAP.

### **Differences in Equity Transactions by Our Subsidiaries**

#### *Effects of Dilution Gains*

Transactions conducted by our consolidated subsidiaries or associated companies, using their common equity as currency, directly result in a reduction of our ownership percentage. Under German GAAP, we recognize dilution gains from share issuances by subsidiary or associated companies for cash, but do not recognize gains for shares issued in non-cash transactions (for example, as consideration for a business acquisition). Under U.S. GAAP, we recognize dilution gains both for cash and non-cash transactions.

### **Differences in Revenue Recognition**

#### *Deferred Income*

Under German GAAP, we recognize revenues in the period when earned by the delivery of goods or the rendering of services. Under U.S. GAAP, we defer certain activation and one-time fees and related direct costs (to the extent of revenues deferred), and amortize these revenues and expenses over the expected duration of our customer relationship. We expense any excess costs as customer acquisition expense. Additionally, we defer revenues on certain other contracts under U.S. GAAP, and amortize these revenues over their contract lives.

### **Differences in Income Taxes**

#### *Deferred Taxes*

Under German GAAP, deferred taxes have not been recognized for temporary differences that arose during tax-free periods, and temporary differences that are not expected to reverse in the foreseeable future. Under U.S. GAAP, deferred taxes generally are recognized for all temporary differences, including temporary differences during tax-free periods. In addition, in contrast to German GAAP, U.S. GAAP requires the recognition of deferred taxes attributable to net operating losses.

As a result of the implementation of SFAS No. 142 in 2002, a number of major wireless carriers in the United States have concluded that the U.S. Federal Communications Commission ( FCC ) wireless spectrum licenses should be considered to be intangible assets with indefinite lives. The classification of our FCC licenses to intangible assets with indefinite lives resulted in the cessation of scheduled amortization of these licenses, effective January 1, 2002. This cessation of amortization affected our assessment as to future realization of deferred tax assets for tax loss carryforwards, resulting in the establishment of a valuation allowance of approximately EUR 4.3 billion during the first quarter of 2002. This negative impact was offset during the third quarter of 2002 by a reduction in the deferred tax liabilities related to the nonscheduled amortization of our mobile communication licenses. Further, we recorded additional deferred tax benefits relating to the recognition of tax deductible goodwill during the fourth quarter of 2002.

### **Other Differences**

In addition to the tax effects of the adjustments for differences between German GAAP and U.S. GAAP described in this section, other differences in our financial results between German GAAP and U.S. GAAP consist primarily of the accounting for capitalization of internally developed software, unrealized gains on marketable securities, deferral of gains on divestitures, asset-backed securitizations, derivatives and investments in equity investees, which historically are recurring differences.

## **NEW U.S. GAAP ACCOUNTING PRONOUNCEMENTS**

In June 2001, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 143 ( SFAS No. 143 ), *Accounting for Asset Retirement Obligations*, which addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development or normal use of the asset. SFAS No. 143 requires that the fair value of a liability for an asset retirement

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obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated long-lived asset and is depreciated over the asset's useful life. The liability is accreted to its present value each period through charges to operating expense. If the obligation is settled for other than the carrying amount of the liability, a gain or loss on settlement is recognized. We are required and plan to adopt the provisions of SFAS No. 143, effective January 1, 2003. To accomplish this, we must identify all legal obligations for asset retirement obligations, if any, and determine the fair value of these obligations on the date of adoption. The determination of fair value is complex and will require us to gather market information and develop cash flow models. Additionally, we will be required to develop processes to track and monitor these obligations. We are assessing the impact that the implementation of this standard will have on our results of operations, financial position and cash flows.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), which replaces Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The types of costs affected by this Standard include certain employee severance costs, contract termination costs and costs to consolidate or close facilities or relocate employees. SFAS No. 146 requires that a liability for costs associated with exit or disposal activities be recognized only when the liability is irrevocably incurred (rather than at the date of management's commitment to an exit or disposal plan). The recognized liability is to be initially measured at fair value and subsequently adjusted for changes in estimated cash flows. The provisions of SFAS No. 146 are effective for exit or disposal activities that are initiated after December 31, 2002. We do not expect the adoption of SFAS No. 146 to have a material impact on our results of operations, financial position and cash flows.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 clarifies and expands the disclosure requirements related to guarantees and product warranties, and requires a guarantor to recognize a liability for the fair value of the obligation it assumes under that guarantee. We have adopted the disclosure requirements applicable to financial statements for periods ending after December 15, 2002. The initial recognition and measurement provisions are applicable prospectively to guarantees issued or modified after December 31, 2002. We do not expect the adoption of FIN 45 to have a material impact on our results of operations, financial position and cash flows.

In December 2002, the Emerging Issues Task Force reached a consensus in EITF Issue 00-21 (EITF 00-21), *Accounting for Revenue Arrangements with Multiple Deliverables*. The Issue addresses a vendor's accounting for transactions involving the delivery of more than one product or service, and when it is necessary to separate the transaction into individual component deliverables, each with its own separate earnings process. If the conditions requiring separate revenue recognition exist, revenue is allocated among the different deliverables based on their relative fair values (the relative fair value of each of the component deliverables to the aggregated relative fair value of the bundled deliverables), with revenue for each component deliverable recognized when the revenue is realized and earned. We are required and plan to adopt the provisions of EITF 00-21, effective July 1, 2003. To accomplish this, we must identify and determine the fair value of the component deliverables. The determination of fair values in our mobile and systems business is complex, as some of the components are price sensitive and volatile in a competitive marketplace. Additionally, we will be required to develop processes to update the relative fair values based upon competitive market conditions. We are assessing the impact that the implementation of this standard will have on our results of operations, financial position and cash flows.

In January 2003, the FASB issued Interpretation No. (FIN 46), *Consolidation of Variable Interest Entities* (VIEs). This interpretation changes the accounting and requirements for consolidation and disclosure of certain entities, including special purpose entities (SPEs). Under FIN 46, an entity is considered a VIE (and subject to consolidation) if its total equity at risk is determined insufficient to finance its activities without additional subordinated financial support, or if its equity investors lack certain characteristics that represent a controlling financial interest. An entity that is considered a VIE would be required to be consolidated by the enterprise that holds a majority of its variable interests (that is, the enterprise that has the most exposure to the economic risks and the potential rewards from changes in the values of the VIE's assets and liabilities). We have adopted Interpretation's disclosure provisions, effective for all financial statements issued after January 31, 2003, which require all holders of variable interests in VIEs to disclose the nature, purpose, size and activities of the VIEs, including the maximum exposure to losses. The consolidation requirements apply to all new VIEs created on and after February 1, 2003, with transitional provisions for VIEs that existed prior to that date. We plan to adopt

the initial and transitional consolidation

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provisions of FIN 46 on February 1 and July 1, 2003, respectively. To accomplish this, we must identify all VIEs, if any, and determine the expected loss and expected residual returns associated with our variable interests. The determination of expected losses and expected residual returns is complex and will require us to develop cash flow models. We do not expect the adoption of FIN 46 to have a material impact on our results of operations, financial position and cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure* ( SFAS No. 148 ), which amends SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS No. 123 ). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in the financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition provisions are effective for financial statements for fiscal years ending after December 15, 2002. The enhanced disclosure requirements are effective for periods beginning after December 15, 2002. Pursuant to SFAS No. 123, we have elected to apply Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for our stock-based compensation plans. Refer to notes (26) and (41) to the consolidated financial statements for discussion of the effect on net income (loss) and other related disclosures had we accounted for these plans under SFAS No. 123, *Accounting for Stock-Based Compensation*.

**New Rules Adopted in 2002:**

During the first quarter of 2002, we adopted the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS No. 144 ). The new standard superseded SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* ( SFAS No. 121 ). SFAS No. 144 retained the requirement of SFAS No. 121 to recognize an impairment loss only if the carrying amounts of long-lived assets to be held and used are not recoverable from their expected undiscounted future cash flows. However, goodwill no longer is required to be allocated to these long-lived assets when determining their carrying amounts. SFAS No. 144 requires that a long-lived asset to be disposed of other than by sale be considered held and used until it is disposed of, requiring the depreciable life to be adjusted as an accounting change. For all long-lived assets to be disposed of by sale, SFAS No. 144 requires that the assets be recorded at the lower of their carrying amount or fair value less cost to sell, and that any remaining depreciation and amortization of these assets cease. Therefore, discontinued operations are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur. The statement also broadens the definition of a discontinued operation to include a component of an entity. Upon the adoption of SFAS No. 144, we recorded an asset impairment charge of approximately EUR 50 million for U.S. GAAP purposes during the first quarter of 2002.

**NEW GERMAN ACCOUNTING STANDARDS (GAS)**

The following new German accounting standards became effective in 2003:

GAS 10	Deferred Taxes in Consolidated Financial Statements
GAS 11	Related Party Disclosures
GAS 12	Non-current Intangible Assets
GAS 13	Consistency Principle and Correction of Errors

GAS 10 *Deferred Taxes in consolidated financial statements* sets out the procedures for accounting for deferred taxes in consolidated financial statements. Deferred taxes should be recognized on timing differences relating to items dealt with through the profit and loss account and which, on reversal in future periods, are expected to result in tax expenses and tax reductions. Quasi-permanent differences should also be treated as timing differences. A deferred tax asset should be recognized on tax loss carryforwards and tax credits to the extent that it is sufficiently probable that the tax benefits from the tax loss carryforwards can be recovered. We have not yet decided if we will adopt GAS 10 during 2003. However, the adoption of GAS 10 during 2003 would result in a substantial increase in our deferred tax assets and stockholders' equity.

GAS 11 Related Party Disclosures requires capital market oriented parent enterprises (*kapitalmarktorientierte Gesellschaften*) to report on relationships with related parties. Related parties are individuals or legal entities which have the ability to control the reporting enterprise (or one of its subsidiaries) or which can exercise, either directly or indirectly, significant influence over the reporting

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enterprise (or one of its subsidiaries). Significant transactions with related parties should be disclosed in the notes to the consolidated financial statements either as an absolute amount or as a proportion of net sales. Receivables and payables (as well as contingent receivables and payables) and pricing policies should also be disclosed. This standard is effective for financial years beginning after June 30, 2002. Since the adoption of GAS 11 affects disclosure only, the adoption of GAS 11 will not have a material effect on our consolidated financial statements.

GAS 12 Non-current Intangible Assets sets out the rules for the recognition and measurement of non-current intangible assets. An intangible asset purchased for consideration should be measured at cost. If the useful life of an intangible asset is limited in time, the acquisition cost should be amortized systematically over its estimated useful life. A review should be performed at each reporting date to determine whether the intangible asset has suffered an impairment in value. Irrespective of whether the useful life of an intangible asset is limited or not limited in time, an intangible asset should be written down to its fair value if this is lower than the carrying amount. The impairment loss should be reversed if the reasons for the impairment loss no longer exist. This standard is effective for financial years beginning after December 31, 2002. We do not expect that the implementation of GAS 12 will have a material impact on our consolidated financial statements.

GAS 13 Consistency Principle and Correction of Errors stipulates that accounting policies be applied consistently from one period to the next. Departure from the consistency principle is only permissible in justified exceptional circumstances. The effect of a change in accounting policies and in consolidation method should be computed retrospectively. Pro forma disclosures should be presented for the previous years' figures. This standard is effective for financial years beginning after December 31, 2002. We do not expect that this will have a material effect on our consolidated financial statements.

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**ITEM 6. Directors, Senior Management and Employees**

**GENERAL**

In accordance with the German Stock Corporation Act (*Aktiengesetz*), we have a Supervisory Board (*Aufsichtsrat*) and a Management Board (*Vorstand*). The two Boards are separate, and according to the German Stock Corporation Act, no individual may simultaneously be a member of both Boards. The Management Board is responsible for managing our company and representing us in our dealings with third parties, while the Supervisory Board appoints and removes the members of the Management Board and generally oversees the management of our company but is not permitted to make management decisions. The official auditor is appointed by the shareholders of the company and is engaged by the Supervisory Board.

Both the members of the Management Board and the members of the Supervisory Board owe a duty of loyalty and care to us. In carrying out their duties, members of both the Management Board and the Supervisory Board must exercise the standard of care of a prudent and diligent businessman. Our interests are deemed to include the interests of the shareholders, the interests of the work force and, to some extent, the common interest, and both the Management Board and the Supervisory Board must take all these interests into account when taking actions or decisions. Although there is no explicit obligation to act solely in the interests of shareholders, the Management Board is required to respect their rights to equal treatment and equal information.

The Supervisory Board has comprehensive monitoring functions. To ensure that these functions are carried out properly, the Management Board must, among other things, regularly report to the Supervisory Board with regard to current business operations and future business planning including any deviation of actual development from formerly reported goals. The Supervisory Board is also entitled to request special reports at any time. Under German law, the Management Board is required to ensure appropriate risk management within our company and to establish an internal monitoring system.

Pursuant to our Articles of Association, the rules of procedure for the Supervisory Board have to contain a provision that the Management Board must obtain the consent of the Supervisory Board for certain actions, including decisions or measures which fundamentally change the assets, financial, earnings or risk situation of the enterprise and measures concerning the corporate structure, acquisitions or dispositions of equity investments above a limit to be determined by the Supervisory Board. In addition, under the German Stock Corporation Act, the Supervisory Board is authorized to subject other actions of the Management Board to its consent.

Under German law, shareholders, like other persons, are prohibited from using their influence on Deutsche Telekom to cause a member of the Management Board or the Supervisory Board to act in a way that is harmful to Deutsche Telekom. A controlling enterprise may not cause us to take measures disadvantageous to us unless any resulting disadvantage is compensated. An individual shareholder or any other person exerting influence on us to cause a member of the Management Board or of the Supervisory Board or holders of special proxies (*Prokuristen* or *Handlungsbevollmaechtigte*) to act in a way that is unfavorable to us or our shareholders is liable for damages to Deutsche Telekom and its shareholders. Board members who have neglected their duties in taking the actions are likewise jointly and severally liable for damages.

As a general rule, under German law, a shareholder has no direct recourse against the members of the Management Board or the Supervisory Board in the event that they are believed to have breached a duty to us. As a general rule under German law, only we have the right to claim damages from the members of the two boards. We may only waive such damages or settle such claims if at least three years have passed and if the shareholders so approve at a shareholders' meeting with a simple majority of the votes, provided that the opposing shareholders do not hold, in the aggregate, one tenth or more of our nominal share capital and do not formally express their opposition at the shareholders' meeting by having their opposition noted in the minutes of the meeting maintained by a German notary (*Notar*).

**SUPERVISORY BOARD**



In accordance with the German Stock Corporation Act (*Aktiengesetz*) and the Co-Determination Act of 1976 (*Mitbestimmungsgesetz*), our Supervisory Board consists of twenty members, ten of whom represent the shareholders and ten of whom represent the employees. Members of the Supervisory Board may be elected for a term of up to five years. Re-election is permitted.

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The Supervisory Board members representing the shareholders are elected at the General Meeting of the shareholders. The first election of shareholder representatives to the Supervisory Board took place at the shareholders meeting in July 1996. The present shareholder representatives were elected at the shareholders meeting in May 2001, except that two members resigned prior to the end of their terms and two new shareholder representatives have been appointed by a local court to replace them pursuant to section 104 of the German Stock Corporation Act. In general, the terms of office of the shareholder representatives expire at the end of the shareholders meeting at which the shareholders discharge the Supervisory Board members in respect of the fourth financial year following the member's commencement of tenure of office. The financial year in which tenure of office commences is not counted for this purpose. The next general election of all of the shareholders representatives on the Supervisory Board will take place at the shareholders meeting in 2006.

Supervisory Board members representing employees were last elected on November 6, 2002, by the employees in accordance with the provisions of the Co-Determination Act of 1976. In this election procedure, employees elect ten representatives made up of workers, regular employees, senior management employees and three union representatives. The terms of office of the employee representatives on the Supervisory Board expire at the end of the shareholders meeting in 2007. Under the law that governed our conversion to a stock corporation, civil servants, who are not covered by the Co-Determination Act, are included in these groups of employee representatives according to their occupations for purposes of these elections.

A member of the Supervisory Board elected by the shareholders may be removed by a shareholders resolution by simple majority of the votes cast. A member of the Supervisory Board elected by the employees may be removed by a majority of at least three quarters of the votes cast by the relevant class of employees.

The Supervisory Board must meet at least twice every six months. To achieve a quorum, at least ten of the members of the Supervisory Board must be present or cast their votes in writing. Except in situations in which a different majority is required by law, such as the appointment of Management Board members and the election of the Chairman and Co-Chairman of the Supervisory Board, the Supervisory Board takes decisions by simple majority of the votes cast. If, in the event of a deadlock, a second vote again results in a tie, the chairman of the Supervisory Board can cast a deciding vote.

**Members of the Supervisory Board of Deutsche Telekom**

The members of our Supervisory Board during 2002, the years in which they were appointed, the months in which their current terms expire and their principle occupations were as follows:

Dr. Hans-Dietrich Winkhaus Chairman (until March 14, 2003)	Member since:	1999
	Expiration of Current Term:	May 2006
	Principal Occupation:	Member of the Shareholders Committee of Henkel KGaA, Duesseldorf
	Supervisory Board Memberships/ Directorships:	ERGO Versicherungsgruppe AG, Duesseldorf Degussa AG, Duesseldorf Deutsche Lufthansa AG, Cologne Schwarz Pharma AG, Monheim, Chairman of the Supervisory Board BMW AG, Munich
Ruediger Schulze Vice Chairman	Member since:	1999
	Expiration of Current Term:	May 2007
	Principal Occupation:	Chairman of Division 9 Telecommunication, Information Technology and Data Processing of the Union ver.di, Berlin
	Supervisory Board	

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Memberships/  
Directorships:

T-Mobile Deutschland GmbH, Bonn  
(previously DeTeMobil Deutsche Telekom  
MobilNet GmbH, Bonn), Vice Chairman of  
Supervisory Board

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Gert Becker	Member since: Expiration of Current Term: Principal Occupation:	1995 May 2006 Former Chairman of the Management Board of Degussa AG, Duesseldorf
	Supervisory Board Memberships/ Directorships:	ALCAN Deutschland GmbH, Eschborn (until 2002) Bankhaus Metzler KGaA, Frankfurt/Main, Chairman of the Supervisory Board Bilfinger + Berger Bau AG, Mannheim, Chairman of the Supervisory Board
Josef Falbisoner	Member since: Expiration of Current Term: Principal Occupation:	1997 May 2007 Chairman of the Bavarian District of the Union ver.di
	Supervisory Board Memberships/ Directorships:	PSD-Bank, Munich, Augsburg office
Dr. Hubertus von Gruenberg	Member since: Expiration of Current Term: Principal Occupation:	2000 May 2006 Serves as member on several Supervisory Boards
	Supervisory Board Memberships/ Directorships:	Allianz-Versicherungs AG, Munich Continental AG, Hannover MAN AG, Munich SAI Automotive, Frankfurt/Main Schindler Holding AG, Hergiswil/ Switzerland, Administrative Board
Dr. sc. techn. Dieter Hundt	Member since: Expiration of Current Term: Principal Occupation:	1995 May 2006 Managing Shareholder of Allgaier Werke GmbH, Uhingen and President of the National Union of German Employers Associations, Berlin
	Supervisory Board Memberships/ Directorships:	EvoBus GmbH, Stuttgart Stauferkreis Beteiligungs-AG, Goepfingen, Chairman of the Supervisory Board Stuttgarter Hofbraeu AG, Stuttgart Stuttgarter Hofbraeu Immobilien Verwaltungs-AG, Stuttgart, Chairman of the Supervisory Board Landesbank Baden-Wuerttemberg, Stuttgart, Administrative Board
Waltraud Litzenberger	Member since: Expiration of Current Term: Principal Occupation:	1999 May 2007 Member of the Works Council of Deutsche Telekom AG, Eschborn branch office
	Supervisory Board Memberships/ Directorships:	PSD-Bank e.G., Koblenz
Michael Loeffler	Member since: Expiration of Current Term:	1995 May 2007

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Principal Occupation:	Member of the Works Council of Deutsche Telekom AG, Dresden branch office
Supervisory Board Memberships/ Directorships:	None

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Hans W. Reich	Member since:	1999
	Expiration of Current Term:	May 2006
	Principal Occupation:	Speaker of the Management Board, Kreditanstalt fuer Wiederaufbau (KfW), Frankfurt/Main
	Supervisory Board	
	Memberships/	Aareal Bank AG, Wiesbaden
	Directorships:	ALSTOM GmbH, Frankfurt/Main HUK-COBURG Haftpflicht-Unterstuetzungs-Kasse kraeffahrender Beamter Deutschlands a.G., Coburg HUK-COBURG Holding AG, Coburg IKB Deutsche Industriebank AG, Duesseldorf RAG AG, Essen Thyssen Krupp Steel AG, Duisburg DePfa Bank plc., Dublin
Wolfgang Schmitt	Member since:	1997
	Expiration of Current Term:	May 2007
	Principal Occupation:	Head of Deutsche Telekom AG s Regional Directorate, South-Western District, Stuttgart
	Supervisory Board	
	Memberships/	PSD-Bank, RheinNeckarSaar e.G.
	Directorships:	
Prof. Dr. Helmut Sihler	Member since:	1996
	Expiration of Current Term:	May 2006
	Principal Occupation:	Vice Chairman of the Administrative Board, Novartis AG, Basel Chairman of the Management Board of Deutsche Telekom AG (from July 2002 until November 2002)
	Supervisory Board	
	Memberships/	Dr. Ing. h.c. F. Porsche AG, Stuttgart,
	Directorships:	Chairman of the Supervisory Board max.mobil Telekommunikations Service GmbH, Vienna (until 2002) Novartis AG, Basel, Vice Chairman of the Administrative Board
Michael Sommer	Member since	2000
	Expiration of Current Term:	May 2007
	Principal Occupation:	President of the Trade Union Council Germany, Berlin
	Supervisory Board	
	Memberships/	BHW Bausparkasse, Hameln
	Directorships:	Postbank, Bonn, Vice Chairman of the Supervisory Board T-Systems International GmbH, Bonn, Vice Chairman of the Supervisory Board
Ursula Steinke	Member since:	1995
	Expiration of Current Term:	May 2007
	Principal Occupation:	Chairwoman of the Works Council at DeTeCSM Northern District Service and Computer Center, Kiel
	Supervisory Board	

Memberships/  
Directorships:

None

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Prof. Dr. h.c. Dieter Stolte	Member since: 1995 Expiration of Current Term: May 2006 Principal Occupation: Editor in Chief of WELT and Berliner Morgenpost, Berlin  Supervisory Board Memberships/ Directorships: Bavaria Film- und Fernsehstudios GmbH, Munich/ Geiseltal, Chairman of the Supervisory Board (until 2002) Out of home Media AG, Cologne ZDF Enterprises GmbH, Mainz, Chairman of the Supervisory Board Sportrechte- und Marketing-Agentur GmbH, Munich, Chairman of the Supervisory Board (until 2002)
Bernhard Walter	Member since: 1999 Expiration of Current Term: May 2006 Principal Occupation: Dresdner Bank AG Supervisory Board Memberships/ Directorships: Bilfinger + Berger Bau AG, Mannheim DaimlerChrysler AG, Stuttgart Henkel KGaA, Duesseldorf mg technologies ag, Frankfurt/Main Staatliche Porzellan-Manufaktur Meissen GmbH, Meissen Thyssen Krupp AG, Duesseldorf Wintershall AG, Kassel Joint Stock Company Sibirsko-Uralskaya Neftegazohimicheskaya Companiya (AK Sibur ), Moscow, until March 2003
Wilhelm Wegner	Member since: 1996 Expiration of Current Term: May 2007 Principal Occupation: Chairman of the Central Works Council at Deutsche Telekom AG, Bonn  Supervisory Board Memberships/ Directorships: VPV Allgemeine Versicherungs-AG, Cologne VPV Holding AG, Stuttgart Vereinigte Postversicherung VVaG, Stuttgart PSD Bank Duesseldorf e.G.

The following persons were appointed to our Supervisory Board in 2002 and 2003:

Monika Brandl	Member since: November 2002 Expiration of Current Term: May 2007 Principal Occupation: Member of the Central Works Council at Deutsche Telekom AG, Bonn  Supervisory Board Memberships/ Directorships: None
Lothar Holzwarth	Member since: November 2002 Expiration of Current Term: May 2007 Principal Occupation: Chairman of the Works Council of Deutsche Telekom AG, branch office South-Western, Stuttgart  Supervisory Board Memberships/ Directorships: PSD Bank RheinNeckarSaar e.G., Chairman of the Supervisory Board





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Dr. Manfred Overhaus	Member since: Expiration of Current Term: Principal Occupation:	November 2002 May 2006 State Secretary in the Federal Ministry of Finance (Bundesministerium der Finanzen), Berlin
	Supervisory Board Memberships/ Directorships:	Deutsche Bahn AG, Berlin (until 2002) Deutsche Post AG, Bonn
Dr. Klaus Zumwinkel Chairman (since March 14, 2003)	Member since: Expiration of Current Term: Principal Occupation:	March 2003 May 2006 Chairman of the Board of Management of Deutsche Post AG, Bonn
	Supervisory Board Memberships/ Directorships:	Deutsche Lufthansa AG, Cologne Tchibo Holding AG, Hamburg Allianz Versicherungs-AG, Munich C.V. International Post Corp. U.A. Amsterdam, Board of IPC, stellv. Vorsitzender Konzernmandate der Deutschen Post AG:

The following individuals resigned from our Supervisory Board in 2002 and 2003:

Rainer Koch	Member since: Resigned: Principal Occupation:	2000 May 2002 Chairman of the Central Works Council of DeTeImmobilien, Deutsche Telekom Immobilien und Service GmbH, Muenster
	Supervisory Board Memberships/ Directorships:	GMG Generalmietgesellschaft mbH, Muenster (until 2002) DeTeImmobilien und Service GmbH, Muenster
Dr. h.c. Andre Leysen	Member since: Resigned: Principal Occupation:	1995 February 2003 Honorary Chairman of the Administrative Board of GEVAERT N.V., Mortsel/ Antwerp, Belgium
	Supervisory Board Memberships/ Directorships:	Agfa-Gevaert AG, Leverkusen, Chairman of the Supervisory Board (until 2002) Bayer AG, Leverkusen (until 2002) E.ON AG, Duesseldorf Schenker AG, Essen Agfa-Gevaert N.V. Mortsel/ Antwerp, Chairman of the Administrative Board (until 2002)
Rainer Roell	Member since: Resigned: Principal Occupation:	1998 May 2002 Vice Chairman of the Central Works Council at Deutsche Telekom AG, Bonn
	Supervisory Board	

Memberships/  
Directorships:                      None

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Prof. Dr. Heribert Zitzelsberger	Member since:	1999
	Resigned	November 2002
	Principal Occupation:	State Secretary in the Federal Ministry of Finance (Bundesministerium der Finanzen)
	Supervisory Board Memberships/	
	Directorships:	None

Each of Mr. Gert Becker, Prof. Helmut Sihler and Dr. Hans-Dietrich Winkhaus, has informed us that they plan to resign from the Supervisory Board with effect from the end of our shareholders' meeting on May 20, 2003. The Supervisory Board therefore will recommend that the following nominees be elected to the Supervisory Board at the shareholders' meeting on May 20, 2003 as shareholder representatives for terms ending in May 2008:

Dr. Hans-Juergen Schinzler, Ottobrunn, Chairman of the Board of Management of Münchener Rüdchversicherungs-Gesellschaft,

Dr. Wendelin Wiedeking, Bietigheim-Bissingen, Chairman of the Board of Management of Dr. Ing. h.c.F. Porsche AG, and

Dr. Klaus G. Schlede, Carabietta/Switzerland, Chairman of the Supervisory Board of Deutsche Lufthansa AG.

Deutsche Post AG and Kreditanstalt fuer Wiederaufbau (KfW) are both majority-owned by our largest shareholder, the Federal Republic of Germany. The Federal Ministry of Finance is a ministry of the Federal Republic of Germany. Among our current Supervisory Board members, Ms. Brandl, Mr. Holzwarth, Ms. Litzberger, Mr. Loeffler, Mr. Schmitt, Ms. Steinke and Mr. Wegner are all employees of Deutsche Telekom group companies.

The shareholder representatives currently on our Supervisory Board are Mr. Winkhaus, Mr. Becker, Mr. von Gruenberg, Dr. Hundt, Dr. Overhaus, Mr. Reich, Dr. Sihler, Dr. Stolte, Mr. Walter and Dr. Zumwinkel.

The Supervisory Board maintains the following committees:

The *Executive Committee (Praesidialausschuss)* is responsible for deciding the terms of the service contracts and other contractual arrangements between Deutsche Telekom AG and the Management Board. In particular, the committee determines salaries and incentive compensation awards for members of the Management Board and establishes goals for performance-based compensation plans. Members of the Executive Committee are Dr. Hans-Dietrich Winkhaus (Chairman, until March 14, 2003); Dr. Klaus Zumwinkel (Chairman, since March 14, 2003), Dr. Andre Leysen (until February 20, 2003), Dr. Manfred Overhaus (since February 21, 2003), Ruediger Schulze and Wilhelm Wegner.

The *Finance and Audit Committee (Finanz- und Pruefungsausschuss / Audit Committee)* is responsible for reviewing and consulting on complex finance and business matters concerning the company. Those matters are delegated by the Chairman of the Supervisory Board or the Supervisory Board itself to the Finance and Audit Committee. The Finance and Audit Committee is the former Committee for Special Matters, which was renamed in May 2002. The Finance and Audit Committee handles issues of accounting and risk management, auditor independence, questions regarding the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement following the German Corporate Governance Code and, with effect from November 2002, matters that the audit committee of a New York Stock Exchange-listed foreign private issuer takes direction of under U.S. law. In addition, the Finance and Audit Committee also reviews our annual report during a meeting with our auditors in preparation for the Supervisory Board's annual meeting on the approval of the Company's financial statements in accordance with section 171 of the German Stock Corporation Act. The members of the Finance and Audit Committee at December 31, 2002, were Dr. Hans-Dietrich Winkhaus (Chairman), Wolfgang Schmitt, Ruediger

Schulze, Bernhard Walter, Wilhelm Wegner and Dr. Manfred Overhaus. For information concerning the relationships that the members of the Finance and Audit Committee have with us, see Members of the Supervisory Board of Deutsche Telekom.

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In addition to the two committees mentioned above, the Supervisory Board has formed a mediation committee and a personnel committee.

Each of the committees of the Supervisory Board has an equal number of shareholder representatives and employee representatives. The chairman of the Supervisory Board also serves as chairman of the Executive Committee. The chairman has the deciding vote in case of tie in the Executive Committee. The chairman of the Finance and Audit Committee is a representative of the shareholders. The chairman of the personnel committee is a representative of the employees.

### **MANAGEMENT BOARD**

Pursuant to our Articles of Association, the Supervisory Board determines the size of the Management Board, subject to the requirement that the Management Board must have at least two members. Since January 16, 2003, our Management Board has seven members. The Supervisory Board may appoint a chairman of the Management Board as well as a deputy chairman. The Supervisory Board appoints the members of the Management Board for a term of up to five years and they may be re-appointed or have their term extended for one or more terms of up to five years. Under certain circumstances, such as a material breach of duty or a bona fide vote of no confidence by the shareholders, the Supervisory Board may remove a member of the Management Board prior to the expiration of the five-year term. A member of the Management Board may not deal with, or vote on, matters relating to proposals, arrangements or contracts between himself and our company. The Management Board takes action by simple majority unless otherwise provided by law, as in the case of a vote on the adoption of Rules of Procedure. In the event of a deadlock, the Management Board member in whose area of responsibility the resolution falls has a deciding vote. If the resolution falls in an area that is not allocated to a Management Board member, the vote of the chairman of the Management Board decides in case of a deadlock.

#### **Members of the Management Board of Deutsche Telekom**

The name, age, term of office, current position and business experience of the members of our Management Board in 2002 are set forth below. The current members of the Management Board may be reached at our registered address.

**Kai-Uwe Ricke**, born in 1961, was appointed chairman of the Board of Management of Deutsche Telekom AG with effect from November 15, 2002. Following an apprenticeship at a bank and studies at the European Business School in Schloss Reichartshausen, Germany, Mr. Ricke started his career as assistant to the Management Board chairman of Bertelsmann AG in Guetersloh. He then took up the position as head of Sales and Marketing of its Swedish subsidiary Scandinavian Music Club AG in Malmoe, Sweden. From 1990 to June 1995, Mr. Ricke was CEO of Talkline and Talkline PS Phone Service in Elmshorn, Germany. From July 1995, he acted as that company's chairman and CEO. In January 1998, Mr. Ricke left Talkline and took over as chairman of the Board of Management of DeTeMobil Deutsche Telekom Mobilnet (today T-Mobile Deutschland GmbH). In February 2000, Mr. Ricke was appointed chairman of the newly founded T-Mobile International AG, where Deutsche Telekom consolidated its principal mobile communications activities. In May 2001, he was appointed to the Board of Management of Deutsche Telekom. As Chief Operating Officer, he was responsible for Deutsche Telekom's mobile and online businesses.

Expiration of current term: November 14, 2007

Other board memberships outside Deutsche Telekom: none

**Josef Brauner**, born in 1950, has been Chairman and CEO of T-Com since February 1, 2003. From May 1, 2001, through January 2003 he was head of CS, which included the divisions T-Com and T-Systems and the operational management of the Networks Infrastructure group and its field organization. He joined Deutsche Telekom in June 1997 as head of the Main Department for Sales and became head of the Sales and Customer Care Division and a member of the Management Board in October 1998. He started his sales career with Avery as the U.S. company's branch manager for Germany, Austria and Switzerland. Mr. Brauner next joined Sony Deutschland, where he was appointed head of sales in the investment goods division and afterwards became

head of that division. In 1988, Mr. Brauner became a member of the Management Board of Sony Deutschland, and in 1993 was appointed chairman of that board. He left Sony in 1997 to join Deutsche Telekom.

Expiration of current term: September 30, 2003

Other board memberships outside Deutsche Telekom: none

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**Dr. Karl-Gerhard Eick**, born in 1954, has been head of the Finance and Controlling Division and a member of the Management Board since January 2000. In November 2002, he was appointed Deputy Chairman of the Management Board. After studying business administration and earning a doctorate, Dr. Eick worked in various positions for BMW AG between 1982 and 1988. From 1989 to 1991, he acted as head of Controlling at WMF AG in Geislingen. In 1991, he became head of the Controlling, Planning and IT Division for the Carl Zeiss group. From 1993 to 1999, he held top management positions with the Haniel group, where he was responsible for the Controlling, Business Administration and IT Division of the strategic management holding company of Franz Haniel & Cie. GmbH.

Expiration of current term: November 30, 2007

Other board memberships outside Deutsche Telekom: Dresdner Bank Luxembourg S.A., Supervisory Board

**Thomas Holtrop** was born in 1954. After studying psychology in 1981, he embarked on a career with Club Mediterranee Deutschland. After various positions in the tourism and advertising world, he moved to American Express in 1989, where he advanced to become Vice President International Business Partners. In 1996, Mr. Holtrop helped set up BANK 24 AG as General Representative and in 1997 he became a member of the Management Board of Deutsche Bank 24 AG. Mr. Holtrop has been Chairman of the Management Board of T-Online International AG since January 1, 2001. He was appointed to the Management Board of Deutsche Telekom AG on December 1, 2002.

Expiration of current term: November 30, 2007

Other board memberships outside Deutsche Telekom: none

**Dr. Heinz Klinkhammer**, born in 1946, was appointed head of Deutsche Telekom's Personnel and Legal Affairs Division and a member of the Management Board in April 1996. Since May 1, 2001, he has been head of Human Resources and from May 1, 2001, until November 30, 2002, he was also head of the department Top Management Staff. Since November 2002 he has been Head of Human Resources and the newly added departments of Organization and Sustainability. Dr. Klinkhammer received a doctorate in law and began his career at the Institute for German and European Labor, Social and Business Law before becoming a Labor Court judge. From 1979 to 1990, he worked at the Ministry of Labor, Health and Social Affairs of the state of North-Rhine/ Westphalia. In 1991, he became Labor Director at Huettenwerke Krupp Mannesmann GmbH and, in 1992, board member of Mannesmannroehren-Werke AG.

Expiration of current term: March 31, 2006

Other board memberships outside Deutsche Telekom: Federal Posts and Telecommunications Agency, Administrative Board, Bonn

The following member of our Management Board joined the Management Board in 2002:

**René Obermann** was born in March 1963. He set up the company ABC Telekom in Muenster after completing a business traineeship with BMW AG in Munich between 1984 and 1986. In 1991, he became Managing Partner of Hutchison Mobilfunk, successor of ABC Telecom. From 1993 to 1998, he was chairman of the company's Management Board. Mr. Obermann was also chairman of the former German Association of Mobile Communication Service Providers in 1995 and 1996. Between April 1998 and March 2000, Mr. Obermann was Managing Director of Sales at T-Mobile Deutschland. From April 2000 until March 2002, Mr. Obermann was CEO of T-Mobile Deutschland. Mr. Obermann became a Member of the management board of T-Mobile International in June 2001, responsible for European Operations. Since December 1 2002, he has been responsible for mobile operations on the Management Board and has served as CEO of T-Mobile International.

Expiration of current term: November 30, 2007



Other board memberships outside Deutsche Telekom: none

The following member of our Management Board was appointed in 2003:

**Konrad F. Reiss**, born in 1957, was appointed to the Management Board of Deutsche Telekom AG and became Chairman of the Management Board of T-Systems International GmbH on January 20, 2003. He began his professional career in 1983 at Vereinigte Papierwerke Schickedanz (marketing and sales management), and in 1998 he was a management consultant at Gruber, Titze und Partner. From 1986 until 1993 Mr. Reiss was founder and managing partner of two Management Consultancies (GTP-IIT and TTP-IHRC). After selling both companies to Cap Gemini, Mr. Reiss held various management positions

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within the Cap Gemini group. Mr. Reiss joined the Management Board of DaimlerChrysler Services AG in 2000, where he was responsible for debis IT-Services (CEO debis Systemhaus). He founded BlueChipBusiness Laboratories in 2001 and was management partner until the end of 2002.

Expiration of current term: January 19, 2008

Other board memberships outside Deutsche Telekom: none

The following members of our Management Board left the Management Board during 2002:

**Jeffrey A. Hedberg**, born in 1961, was head of Deutsche Telekom's International Division and a member of the Management Board from January 1999 until December 31, 2002. Mr. Hedberg, who is a U.S. citizen, joined the TVM/Matuschka group in Munich in 1985, where he was primarily involved in analyzing venture capital projects for companies with international operations. From 1990 to 1992, he worked in the international division of US West, and then as an associate at Coopers & Lybrand in international projects of the globally active telecommunications group. In 1994, Mr. Hedberg joined Swisscom, where he was in charge of international investments as Executive Vice President and member of the company's senior management.

End of term of appointment: December 31, 2002

Other board memberships outside Deutsche Telekom: none

**Dr. Max Hirschberger**, born in 1956, was a member of the Management Board from April 11, 2001, until November 30, 2002. Dr. Hirschberger was responsible for the Corporate Affairs Division from May 1, 2001, which combined Legal Affairs, Strategy, Organization, Internal Auditing and Information Management. After having studied law in Regensburg and Lausanne and obtaining a Masters degree at the University of Michigan, Dr. Hirschberger joined the Legal Affairs Department at BMW AG in Munich in 1987. From 1994 he was the head of the Department for Corporate and International Law. He joined Deutsche Telekom in 1997 when he became head of the newly established Deutsche Telekom group office. In this capacity, he was responsible for the support office of the chairman of the Management Board.

End of term of appointment: November 30, 2002

Other board memberships outside Deutsche Telekom: none

**Prof. Dr. Helmut Sihler**, born in 1930, was chairman of the Management Board from July 17, 2002, until November 14, 2002. He studied in Graz and Vermont, USA, receiving doctorates in philology and law. In 1957, he joined Henkel KGaA in Duesseldorf. From 1980 to 1992, Prof. Sihler was chairman of the Henkel Management Board. From July 1996 until May 2000 he acted as chairman, and since May 2000 he has served as an ordinary member of the Supervisory Board of Deutsche Telekom AG. During the period of his chairmanship of the Management Board in 2002, his Supervisory Board mandate was temporarily suspended. Prof. Sihler is also chairman of the Supervisory Board of Porsche AG in Stuttgart.

End of term of appointment: November 14, 2002

Other board memberships outside Deutsche Telekom: Novartis AG, Basel Vice President of the Administrative Board; Dr. Ing. h. c. F. Porsche AG, Stuttgart Chairman of the Supervisory Board

**Dr. Ron Sommer**, born in 1949, was chairman of the Management Board from May 1995 until July 16, 2002. He received a doctorate in mathematics and began his career with the Nixdorf group, first in New York and then in Paderborn and Paris. In 1980, he became managing director of Sony Deutschland and in 1986 became chairman of the Management Board of Sony Deutschland. In 1990, Dr. Sommer became president and chief operating officer of Sony Corporation of America, and in 1993, he took over the management of Sony Europe in the same capacity.

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End of term of appointment: July 16, 2002

Other board memberships outside Deutsche Telekom: Muenchner Rueckversicherungs-Gesellschaft AG,  
Munich

**Gerd Tenzer**, born in 1943, was appointed head of the Networks Division in January 1990 and was a member of Deutsche Telekom's Management Board since January 1995, responsible for Networks, Purchasing, and Environmental Protection. Since May 1, 2001, he was responsible for Production, Technology, Innovation Management, Purchasing and Environmental Protection and in July 2002 he was appointed Deputy Chairman of Deutsche Telekom AG. As a communications engineer, he worked in the telecommunications research department at AEG-Telefunken from 1968 to 1970. In 1970, he joined what was

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then the Deutsche Bundespost. In 1975, Mr. Tenzer moved to the Federal Ministry of Posts and Telecommunications, where he became head of the Telecommunications Policy Section in 1980. From 1990 to 1994, he was a member of the Management Board of Deutsche Bundespost Telekom.

End of term of appointment: November 28, 2002

Other board memberships outside Deutsche Telekom: VDE GmbH, Supervisory Board, Frankfurt; Bonn-Innova GmbH & Co. Venture-Beteiligungs KG, Chairman of the Supervisory Board (from March 2002 until November 2002); SES Global A.A., BoD, Betzdorf, Luxembourg; SES Astra S.A., BoD, Betzdorf, Luxembourg (until December 2002)

## **COMPENSATION**

### **Supervisory Board Compensation**

The Articles of Association provide for annual compensation of EUR 50,000 for the chairman, EUR 37,500 for the deputy chairman and EUR 25,000 for each remaining member of the Supervisory Board. In addition, members of the Supervisory Board are entitled to reimbursement of actual out-of-pocket expenses and to receive an attendance fee amounting to EUR 200 for each meeting of the Supervisory Board or its committees. The value-added tax payable on this compensation is borne by us. These compensation rules applied for the first time for the 1999 financial year. For Supervisory Board members who served on the board for only part of the year, we paid a fraction of their total compensation based on the number of months they served, rounding up to whole months. The remuneration for members of our Supervisory Board for 2002 amounted to EUR 615,815, inclusive of meeting expenses (and including value-added tax according to article 13 paragraph 3 of the Articles of Association). The remuneration for fiscal year 2002 has been paid out in two steps: the first half in July 2002 and the second half in December 2002.

None of the members of the Supervisory Board has a service contract with us or any of our subsidiaries providing for benefits upon termination of employment.

### **Management Board Compensation**

The aggregate remuneration of our Management Board for 2002 amounted to EUR 14,478,818.28. This amount includes cash payments and reserves for variable compensation as well as fringe benefits, imputed income, and set-asides for costs associated with changes in our Management.

A portion of the total compensation of the Management Board is paid pursuant to a bonus arrangement. The bonus payment is determined by the Supervisory Board and is based upon three performance targets, each of which is weighted one third in determining the total bonus payment:

Company targets of Deutsche Telekom AG (consisting of financial and strategic targets)

Individual targets of each Management Board member (a Management Board member's success in meeting particular goals set for his business area)

Overall performance of each Management Board member (designed to reward intangible aspects of performance such as leadership)

Company targets and individual performance targets are set by the Supervisory Board at the beginning of each fiscal year.

For the year ended December 31, 2002, about 40% of the total remuneration was paid pursuant to this bonus arrangement.

In addition, a proposal to establish a stock option program for the members of the Management Board and key employees was approved at the shareholders' meeting in May 2001. No options were granted to members of

our Management Board during 2002.

For further information on this program, see Share Ownership below and notes (26) and (43) to the Consolidated Financial Statements.

Pension accruals totaling EUR 47,207,841.00 have been established in our books for both, active and former members of the Management Board as of December 31, 2002.

Obligations for such persons for which no reserve has been established amounted to EUR 3,368,531.00 as of December 31, 2002.

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Payments to and set-asides for former members of our Management Board or their surviving family members in respect of their service as members of the Management Board amounted to EUR 26,437,713.11 in 2002. This amount includes all reserves for anticipated payments to former members of our Management Board, as required under German law disclosure requirements.

None of the members of the Management Board has a service contract with us or any of our subsidiaries providing benefits upon termination of employment. The duration of employment contracts with Management Board members corresponds to the duration of their appointments to office. If a Management Board member leaves his or her post before the end of term, we will perform or otherwise discharge our remaining contractual obligations, unless the Management Board member has terminated the contract or we terminate the contract for material cause.

## **Stock Option Plans**

At the shareholders' meeting on May 25, 2000, an amendment to the Articles of Association was approved that created conditional capital of up to EUR 64 million for the issuance of up to 25 million shares upon exercise of options granted to management and key employees in connection with a stock-based compensation plan adopted in May 2000 (the Stock Option Plan 2000). At the shareholders' meeting on May 29, 2001, an amendment to the Articles of Association was approved that cancelled the conditional capital created in May 2000, except for the nominal amount of EUR 2,621,237.76, which serves to grant subscription rights already issued to members of the Management Board and our executives, as well as members of the management boards and other executives of our second-tier and lower-tier subsidiaries under our Stock Option Plan 2000. Further, the shareholders' meeting on May 29, 2001, approved the cancellation of the authorized capital for our Stock Option Plan 2000 of up to EUR 12.8 million approved by the shareholders' meeting on May 25, 2000, for the purpose of issuing up to 5 million new shares for our Stock Option Plan 2000.

At the shareholders' meeting on May 29, 2001, a further amendment to the Articles of Association was approved that conditionally increased our registered share capital by up to a nominal amount of EUR 307.2 million by issuance of up to 120 million new shares. This conditional share capital may only be used if and to the extent that subscription rights granted pursuant to our Stock Option Plan 2001 described in notes (26) and (40) to the consolidated financial statements are exercised and new shares are delivered upon such exercise. Subscription rights that have not been or may not be exercised prior to the expiration of the exercise period will expire. Shares issued from the conditional share capital generally will be entitled to any dividends paid in respect of the year in which they are issued. Shares that are issued after the end of any fiscal year, but before the ordinary general shareholders' meeting at which the appropriation of the net profit for the year will be decided upon, will be entitled to any dividends paid in respect of that year. The shareholders' resolution authorized our Supervisory Board to grant stock options to the members of its Management Board and authorized the Management Board to grant stock options to all other eligible participants.

The shareholders' resolution authorized our Supervisory Board to determine the detailed terms for the issuance of shares from the conditional share capital and for the grant of options as well as the other terms of the stock option plan if the Management Board is the beneficiary of the stock option plan. In all other cases, the Management Board is authorized to make these determinations.

For further information regarding stock-based compensation plans, including the numbers of options granted, exercise prices and expiration dates, please refer to notes (26) and (40) to the consolidated financial statements. See Item 8. Financial Information - Litigation for a description of litigation with respect to the Stock Option Plan 2000.

## **SHARE OWNERSHIP**

The members of our Management Board owned a total of 18,967 Deutsche Telekom shares and options in respect of a total of approximately 824,600 Deutsche Telekom shares as of January 24, 2003. No individual member of the Management Board beneficially owned 1% or more of our outstanding shares as of January 24, 2003.



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On an individual basis, the members of our Management Board beneficially owned the following number of Deutsche Telekom shares as of January 24, 2003:

Name	No. of Shares Beneficially Owned
Current members	
Kai-Uwe Ricke	none
Josef Brauner	800
Dr. Karl-Gerhard Eick	none
Thomas Holtrop	none
Dr. Heinz Klinkhammer	4,000
Rene Obermann	none
Konrad F. Reiss	1,000
Former members who served on Management Board during 2002	
Jeffrey A. Hedberg	3,000
Dr. Max Hirschberger	446
Dr. Ron Sommer	4,726
Prof. Dr. Helmut Sihler	1,852
Gerd Tenzer	3,143
<b>Total</b>	<b>18,967</b>

The members of the Supervisory Board owned a total of 9,787 Deutsche Telekom shares as of January 24, 2003. No individual member of the Supervisory Board beneficially owned 1% or more of our outstanding shares at January 24, 2003.

On an individual basis the members of our Supervisory Board beneficially owned the following number of Deutsche Telekom shares as of January 24, 2003:

Name	No. of Shares Beneficially Owned
Current members	
Dr. Hans-Dietrich Winkhaus	2,498
Ruediger Schulze	none
Gert Becker	none
Monika Brandl	372
Josef Falbisoner	512
Dr. Hubertus von Gruenberg	none
Lothar Holzwarth	642
Dr. sc. techn. Dieter Hundt	none
Waltraud Litzenberger	108
Michael Loeffler	97
Dr. Manfred Overhaus	none
Hans-W. Reich	none
Wolfgang Schmitt	2,510
Prof. Dr. Helmut Sihler	1,852
Michael Sommer	none
Ursula Steinke	400
Prof. Dr. h.c. Dieter Stolte	none
Bernhard Walter	none
Wilhelm Wegner	335



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Dr. Klaus Zumwinkel	none
Former members who served on Supervisory Board during 2002	
Rainer Koch	111
Dr. h.c. Andre Leysen	none
Rainer Roell	350
Prof. Dr. Heribert Zitzelsberger	none
	<hr/>
Total	9,787
	<hr/>

No stock options have been granted to members of our Supervisory Board.

**Table of Contents****EMPLOYEES AND LABOR RELATIONS****Employees**

As of December 31, 2002, the companies within the Deutsche Telekom consolidated group employed a workforce of 255,969 people worldwide, excluding interns and apprentices. This represents a decrease of 0.4% from year-end 2001.

The table below provides a geographic breakdown of our workforce at the dates indicated.

	<b>For the year ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Deutsche Telekom group employees<sup>(1)</sup></b>	255,969	257,058	227,015
Thereof:			
Germany	177,823	178,336	179,197
European Union outside of Germany	17,647	16,538	16,577
Other European countries	39,601	43,343	29,408
North America	19,144	16,909	170
Rest of the world	1,754	1,932	1,663

(1) Employees excluding interns.

The following table shows the number of employees within the Deutsche Telekom consolidated group as well as within Deutsche Telekom AG at the dates indicated. First presented is the number of civil and non-civil servant employees and, second, a breakdown showing our workforce by divisions.

**Deutsche Telekom group employees<sup>(1)</sup>**

	<b>For the year ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Deutsche Telekom AG</b>	120,009	124,328	126,857
Thereof:			
Civil servants	50,776	54,615	59,901
Salaried employees and wage earners <sup>(2)</sup>	69,233	69,713	66,956
<b>Deutsche Telekom group<sup>(4)</sup></b>	255,969	257,058	227,015
Thereof:			
Civil servants	50,776	54,615	59,901
Salaried employees and wage earners	205,193	202,443	167,114
Thereof: <sup>(3)</sup>			
T-Com	148,900	155,342	144,969
T-Systems	43,292	43,449	40,672
T-Mobile	41,597	38,025	19,186
T-Online	2,814	2,960	3,010
Other activities	19,366	17,282	19,178

During fiscal year 2002, we did not employ a significant number of temporary employees.

(1) Employees excluding interns.

- (2) Thereof 8,421 civil servants temporarily without civil servant status at December 31, 2002. Civil servants temporarily without civil servant status have voluntarily suspended their civil servant status in order to take positions or accept employment conditions within the group that are for legal or practical reasons incompatible with civil servant status. They have the right to reclaim civil servant status and the benefits associated with that status when they have concluded their non-civil servant assignments.
- (3) The figures for 2000 and 2001 have been restated to correspond with the organizational structure of the Deutsche Telekom consolidated group for the year 2002.
- (4) Thereof 28,596 employees and civil servants that have been transferred from Deutsche Telekom AG to subsidiaries with the right to return to Deutsche Telekom AG.

***Employee Relations***

In Germany, works councils (*Betriebsraete*), whose members are elected by the employees, represent the interests of the employees vis-à-vis the employer in accordance with the Works Council Act of 1972 (*Betriebsverfassungsgesetz*), as amended. Works councils are established locally, as well as at a company level and at the group level. Works councils must be notified in advance of, and have the right to comment on, proposed employee terminations, relocations and other matters, and have codetermination rights in respect

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of certain social matters, including work schedules and rules of conduct. In 2001, the German Federal Government enacted amendments to the Works Council Act that increase the influence of works councils in some matters, such as the obligation to exempt an additional number of members of the Works Councils from their regular work within companies with more than 200 employees (previously 300). Furthermore, based on the requirements of the Act on European Works Councils (*Gesetz ueber europaeische Betriebsraete*) we will establish in 2003 a European works council, which will only have the right to information and consultation and not the right to participate in the decision making process.

Traditionally we had a good relationship with our works councils and the unions, and their cooperation is very important to us, including with regard to our work force reduction plans. Constructive relations with our employees and their representatives are of central importance to us.

***Civil Servants***

As of December 31, 2002, approximately 19.8% of our group's employees were German civil servants. No employees hired after January 1, 1995, have been granted civil servant status. Pursuant to the laws that applied to our conversion to a stock corporation, our civil servant employees retained their civil servant status when that conversion occurred. As such, the terms and conditions of their employment and the benefits owed to them continue to be governed by German regulations regarding civil servants. In particular, civil servant salaries are set by statute and not by us or by collective bargaining agreements. In addition, civil servants are tenured employees and may not be unilaterally terminated except in extraordinary, statutorily defined circumstances. Civil servants are not permitted to participate in work-related actions such as strikes, but are permitted to join labor unions. Although we are authorized pursuant to the law governing our privatization to exercise generally the rights and duties of the Federal Republic as the employer of civil servants, the Federal Postal and Telecommunications Agency (*Bundesanstalt fuer Post und Telekommunikation* or Federal Agency) has a right of consultation in the implementation of certain aspects of the terms under which we employ civil servants.

Civil servants employed by us are entitled to pension benefits provided by the Federal Government pursuant to the German Civil Servant Pension Act (*Beamtenversorgungsgesetz*). Pursuant to the law governing our privatization, we are required to make annual contributions to a special pension fund established to fund such pension obligations. The special pension fund was merged in 2000 with the special pension funds of Deutsche Post AG and Deutsche Postbank AG to form the joint pension fund Bundes-Pensions-Service fuer Post und Telekommunikation e.V. (BPS-PT). The BPS-PT works for the funds of all three companies and also handles the financial administration for the Federal Republic on a trust basis. All transactions for pension and allowance payments are made for the companies Deutsche Post AG, Deutsche Postbank AG and Deutsche Telekom AG.

In accordance with the provisions of the Post and Telecommunications Reorganization Act (*Gesetz zur Neuordnung des Postwesens und der Telekommunikation*), this pension fund makes pension and allowance payments to retired employees and their surviving dependents who are entitled to pension payments as a result of civil servant status. Since 2000, we have been legally obligated to make an annual contribution to the special pension fund of 33% of the gross remuneration of active civil servants and the imputed gross remuneration of civil servants temporarily without civil servant status entitled to pension payments. These contributions amounted to approximately EUR 838 million in 2002, EUR 845 million in 2001 and EUR 895 million in 2000. A fixed annual contribution of EUR 1.5 billion was payable for the years 1995 through 1999.

The Federal Republic compensates the special pension fund for differences between the ongoing payment obligations of the special pension fund, amounts received from us and returns on assets, and guarantees that the special pension fund is always in a position to fulfill the obligations it has assumed. The Federal Republic cannot require reimbursement from us for amounts paid by it to the special fund.

***Other Employees***

As of December 31, 2002, approximately 80.2% of our group's employees were non-civil servants. In addition to being covered by collective bargaining agreements, the non-civil servant employees in Germany are in general covered by the German Termination Protection Act (*Kuendigungsschutzgesetz*), which imposes various restrictions on the involuntary termination of employment.

The majority of our employees in Germany are organized in unions, principally the union ver.di (*Vereinte Dienstleistungsgewerkschaft*). Further, the company has labor contracts negotiated with smaller

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unions (DPVKOM/CGPT). Due to our acquisition of debis Systemhaus GmbH, the union IG Metall (*Industriegewerkschaft Metall*) also represents some employees of T-Systems. The terms and conditions of employment and salary increases for non-civil servant employees are negotiated between the unions and us. Pursuant to the law governing our privatization, the Federal Postal and Telecommunications Agency is responsible for concluding collective bargaining agreements relating to certain statutorily defined non-wage benefits, rules of conduct and other general terms of employment. Such agreements only become effective with our consent. For further information regarding agreements between us and the Federal Postal and Telecommunications Agency, see Item 7. Major Shareholders and Related Party Transactions Related Party Transactions.

We and the union ver.di concluded a new collective bargaining agreement in May 2001 that included the introduction of a new evaluation and pay system as of July 1, 2001. As a result, we completed the phase out of our old pay system, which was based on civil-service regulations. Now, employee pay is based on the position in which an employee serves and no longer reflects criteria such as age, marital status or seniority. The new pay system increased the performance-based component of employee pay. Furthermore, a single collective bargaining agreement now applies throughout all of Germany, in the same manner and with the same terms. The collective bargaining agreement signed in May 2000 had already introduced a performance pay component for all employees. As of July 2001, the existing performance-based component of 2.15% of total pay was increased to 6% and in July 2002 to 7%. Our target is to increase the performance-based share of compensation to up to 10% during the coming collective bargaining rounds. The implementation process of the new evaluation and pay system has been almost finalized.

Collective bargaining agreements relating to remuneration between the German unions and us typically have a term of one year.

In June 2002, the ver.di union and we signed a collective agreement concerning employee rationalization matters within Germany. This agreement contains provisions providing protection in the case of rationalization-related job cuts affecting employees covered by collective agreements and our apprentices who have successfully completed their training. In accordance with these provisions, a Personnel Service Agency has been established within Deutsche Telekom AG. This Agency has as its primary task the absorption of covered employees affected by rationalization measures and, after appropriate retraining if necessary, the placement of those employees in vacant positions in and outside the Deutsche Telekom group. If no appropriate positions are vacant, the employees may, for limited periods, be assigned to third-party companies in or outside the group for a fee in accordance with the provisions of the German Law Concerning Employee Secondment (*Arbeitnehmeruberlassungsgesetz*). In this case, the employees remain employees of Deutsche Telekom AG and their contractual rights and obligations (under the terms of collective agreements) are not affected by the assignment. Apprentices who have successfully completed their training at Deutsche Telekom AG are transferred to the Personnel Service Agency for a limited period of one year immediately after the completion of their training. In this case, too, the task and objective of the Personnel Service Agency is to find long-term positions for the apprentices in or outside the Deutsche Telekom group.

Our intention in establishing the Personnel Service Agency is to facilitate our reduction of excess staffing and to achieve long-term, efficient management of our workforce, while avoiding compulsory redundancies. The transfer of employees to the Personnel Service Agency commenced in January 2003. The costs associated with employees transferred to the Personnel Service Agency will be reflected in the results of our Other Activities segment, but the operating divisions from which the employees come from have to pay a reimbursement to the Personnel Service Agency.

For further information on the effects of these collective bargaining agreements on our personnel expenses, see Item 5. Operating and Financial Review and Prospects Consolidated Results of Operations Personnel Costs.

For information concerning our pension plan arrangements for non-civil servant employees, refer to note (27) to our consolidated financial statements and to Item 5. Operating and Financial Review and Prospects Critical Accounting Policies under German GAAP.



Table of Contents**ITEM 7. Major Shareholders and Related Party Transactions****MAJOR SHAREHOLDERS**

Historically, we formed an integral and undifferentiated part of Deutsche Bundespost, a state-owned special asset (*Sondervermoege n des Bundes*). In 1989, Deutsche Bundespost was divided into three distinct entities Deutsche Bundespost TELEKOM, Deutsche Bundespost POSTBANK and Deutsche Bundespost POSTDIENST. Deutsche Bundespost TELEKOM was transformed, with effect from January 1, 1995, into Deutsche Telekom AG, a private law stock corporation, which initially remained wholly owned by the Federal Republic.

At December 31, 2002, the Federal Republic's direct ownership interest in our company was approximately 30.75%. Kreditanstalt fuer Wiederaufbau (KfW), a development bank that is 80% owned by the Federal Republic and 20% owned by the German federal states, owned 12.02% of our shares as at December 31, 2002. KfW acquired its shareholdings in our company from the Federal Republic in several tranches between 1997 and 1999. These acquisitions were made on the basis of agreements pursuant to which KfW acquired shares from the Federal Republic at a discount from the relevant market price. These agreements provide that, in case of a subsequent sale of the shares by KfW, the Federal Republic will receive from KfW the difference between (i) the sale price and (ii) the sum of the purchase price paid, certain costs and a portion of any capital gain realized by KfW on the sale.

The Federal Republic administers its shareholding and exercises its rights as a shareholder of Deutsche Telekom through the Federal Agency, which is subject to the supervision of the Finance Ministry. In its capacity as shareholder, the Federal Republic or KfW may exercise only those rights that it has under the German Stock Corporation Act and our Articles of Association (*Satzung*). For further information regarding the Articles of Association, please refer to Item 10. Additional Information Articles of Association.

At present, the Finance Ministry and KfW each have one representative on our Supervisory Board. Furthermore, the Finance Ministry has one representative on the Supervisory Boards of our subsidiaries T-Systems International GmbH, T-Online International AG and T-Mobile International AG. See Item 6. Directors, Senior Management and Employees General Supervisory Board for a description of rights and responsibilities of the members of the Supervisory Board.

The table below sets forth the number of our ordinary shares held by holders of more than 5% of our ordinary shares and their percentage ownership, based on information available to us, as of the dates indicated.

**For the year ended December 31,**

Identity of Person or group	2002		2001		2000	
	Shares owned	%	Shares owned	%	Shares owned	%
Federal Republic of Germany	1,290,835,401	30.75%	1,297,896,644	30.92%	1,297,485,401	42.83%
Kreditanstalt fuer Wiederaufbau	504,590,664	12.02%	509,164,599	12.13%	509,164,599	16.81%
		<u>42.77%</u>		<u>43.05%</u>		<u>59.64%</u>

As noted above, KfW is 80% owned by the Federal Republic. The Federal Republic has publicly stated its intention to reduce substantially its ownership of Deutsche Telekom shares. According to press reports the Federal Republic intends to sell a further stake to KfW on the basis of above-mentioned arrangement during 2003. We can offer no assurance as to the timing or manner of any such reduction.



**RELATED PARTY TRANSACTIONS**

**Relationship with the Federal Republic**

As is generally the case with other German corporations with a controlling shareholder, for as long as the Federal Republic is a shareholder with controlling influence (*beherrschender Einfluss*), our Management Board is required to produce a report (*Abhängigkeitsbericht*) setting forth the relationships and the transactions entered into between us, on the one hand, and the Federal Republic or its affiliated enterprises, on the other hand. This related-party report, which is intended to protect minority shareholders and creditors, must include a declaration by the Management Board as to the fairness of transactions and dealings with the Federal Republic. Our independent auditors are required to confirm the accuracy of this report. The Supervisory Board is then required to review the related-party report and the auditor's findings thereon and to

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inform the shareholders as to the conclusion of both. In the 2002 related-party report, our Management Board declared that under the circumstances known to the Management Board, at the time of performing the business transactions between us and the Federal Republic and its affiliated enterprises, including the Federal Agency, we received appropriate remuneration for these transactions, and that we did not perform or omit any actions on behalf of or on the instructions of the controlling shareholder, in its capacity as such, or any other affiliated companies. Our independent auditors have confirmed the accuracy of the 2002 related-party report regarding relationships between our controlling shareholder and us.

### **Coordination and Administrative Responsibilities of the Federal Agency**

Pursuant to German law, the Federal Agency provides certain services to Deutsche Telekom, Deutsche Postbank and Deutsche Post and has certain rights and responsibilities with respect to the administration of the common affairs of these companies. For example, the Federal Agency is responsible for concluding general collective bargaining agreements (*Manteltarifvertraege*) on behalf of these entities with employees relating only to certain non-wage benefits, rules of conduct and other general terms of employment. These agreements only become effective with the consent of the affected entity. The Federal Agency's right to conclude these agreements does not affect our right to negotiate particular terms of employment, including wages, salaries and conditions of employment, independently on our own behalf. The Federal Agency also administers the health insurance fund for civil servants (*Postbeamtenkrankenkasse*) and the pension fund for non-civil servants (VAP) employed by Deutsche Postbank, Deutsche Post, others and us. The Federal Agency has certain additional responsibilities and rights with respect to civil servants employed by us, Deutsche Post and Deutsche Postbank. The Federal Agency has the right to provide advice concerning the coordination of the activities of us, Deutsche Postbank and Deutsche Post, particularly, with respect to their public image, issues that may arise if the business plans of these entities conflict and, upon request, with respect to certain personnel issues.

Services provided by the Federal Agency pursuant to applicable law are rendered on the basis of service agreements between us, Deutsche Postbank or Deutsche Post, on the one hand, and the Federal Agency, on the other. Since German law currently requires that each of Deutsche Telekom, Deutsche Postbank and Deutsche Post enter into a service agreement with the Federal Agency covering the services described above, we have not considered entering into arrangements with third parties for the provision of these services. Costs of the Federal Agency incurred in connection with providing these services are financed out of fees agreed upon with us, Deutsche Post and Deutsche Postbank. We paid costs of EUR 64.5 million for these services in 2002 (as compared to EUR 70.1 million in 2001).

The total costs of the Federal Agency, consisting mainly of personnel costs for its employees, are allocated pursuant to the cost attribution system of the Federal Agency in accordance with actual expenses.

### **Federal Republic as Regulator**

The Federal Republic's role as regulator is independent and distinct from its role as shareholder. This regulatory function is exercised by the Regulatory Authority. The telecommunications licenses held in Germany by us were acquired from the Federal Republic or its agencies. See Item 4. Information on the Company Regulation.

### **Federal Republic and Affiliated Entities as Customers**

The Federal Republic is our largest customer and purchases services on an arm's-length basis. We deal with the various departments and agencies of the Federal Republic as separate customers, and the provision of services to any one department or agency does not constitute a material part of our revenues. We have also entered into contracts to provide telecommunications services to entities affiliated with the Federal Republic on an arm's-length basis in the ordinary course of business.

We are a partner in a consortium that has contracted with the Federal Republic to develop and operate a toll collection system for use with certain commercial vehicles traveling on roadways in Germany. Pursuant to this arrangement, we have, along with our partners, guaranteed, on a joint and several basis, the successful completion and operation of the toll collection system. In the event that the toll collection system is not completed on schedule, or does not operate effectively upon completion, the amount of revenues to be received

by the operating joint venture company pursuant to this arrangement may be significantly reduced, and the operating joint venture company may be subject to significant penalties as well. Further, there are no restrictions on the ability of the Federal Republic to recover damages. For more information, see Item 5. Operating and Financial Review and Prospects Contractual Obligations and Other Commitments.

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### **Partnerships with Certain Federal States**

We have formed strategic partnerships with certain German federal states for the purpose of collaborating on opening up new fields of application for modern information and communications technology.

The strategic cooperation arrangements that currently exist with 10 federal states and which are set forth in agreements having terms of four or five years involves projects that are worked out together and financed on a basis of parity. The greater part of our financial contribution is in the form of physical resources and services.

### **Arrangements with Deutsche Post**

We entered into an agreement with Deutsche Post in 2000 that calls for us to provide, among other things, information technology and corporate network services to Deutsche Post. In return, Deutsche Post provides distribution and transportation, printing, warehousing and other services. The objective of the arrangement is to allow each company to focus on its core competencies and dispose of peripheral activities. This arrangement resulted in a net transfer of around 1,500 of our employees to Deutsche Post in 2001 and 2000. The new Chairman of our Supervisory Board is also the Chairman of the Management Board of Deutsche Post AG and Chairman of the Supervisory Board of Deutsche Post AG.

### **Arrangements with Deutsche Postbank**

We have a credit facility with Deutsche Postbank providing us with a line of credit of up to EUR 200 million. At December 31, 2002, that credit facility had been drawn upon in the amount of GBP 43 million (EUR 66 million) with an interest rate of 4.3% per year.

We have agreements with a number of banks, including Deutsche Postbank, pursuant to which we can draw on credit facilities up to EUR 12 billion according to a consortium credit facility agreement. The level of the interest rates depends on our rating, the amount of the consortium credit and the LIBOR rate plus margin ranking to be applied, from 0.275% to 0.500%. The loan commitment fee is between 0.050% and 0.200% and also depends on our rating. There were no outstanding debts relating to the consortium credit facility at the end of 2002.

We engage in a variety of other routine commercial banking relationships with Deutsche Postbank.

### **Arrangements with KfW**

In 2000, our Dutch finance subsidiary, Deutsche Telekom International Finance B.V., entered into three loan agreements with KfW in the amount GBP 150 million each, which are guaranteed by Deutsche Telekom AG. The level of the interest rates depends on our rating. The loans have a maturity of five, seven and ten years, respectively.

### **Federal Republic Guarantees**

Under German law, all of our liabilities outstanding as of January 2, 1995, the date of Deutsche Telekom's registration in the Commercial Register (*Handelsregister*), became guaranteed by the Federal Republic. This guarantee replaced the Federal Republic's obligations with respect to our liabilities when it was a state-owned special asset. The Federal Republic does not guarantee liabilities we incurred after January 2, 1995.

### **Pension Contributions for Civil Servants**

Civil servants (*Beamte*) employed by us are entitled to pension benefits provided by the Federal Republic. Under German law, we are required to make annual contributions to a special pension fund (*Unterstützungskasse*) established to fund these pension obligations. For further information, see Item 6. Directors, Senior Management and Employees Employees and Labor Relations and Item 5. Operating and Financial Review and Prospects Consolidated Results of Operations Personnel Costs.

**Investigation of Bonn Public Prosecutor**

We are advancing funds to cover the legal expenses being incurred by current and former board members in connection with the Bonn public prosecutors investigation of certain real estate valuation-related questions and other matters. See Item 8. Litigation Investigation for a description of this investigation.

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These funds will be required to be repaid to us if there is a final determination that these individuals violated the law.

**DT 3 Offering**

In connection with the global offering by KfW of equity securities of Deutsche Telekom in June 2000, we agreed to bear certain offering-related expenses in view of the benefits accruing to us from the offering. We, the Federal Republic and KfW agreed to indemnify the underwriters for the offering against certain liabilities, including liabilities under the U.S. Securities Act of 1933, in the manner provided for in the underwriting agreement. The underwriting agreement allocated among us, the Federal Republic and KfW indemnification responsibility for different sections of the disclosure materials, with us taking responsibility vis-a-vis the underwriters for, among other things, the parts of the disclosure materials concerning its business and financial statements. Additionally, we agreed with KfW to assume responsibility for errors, if any, in the translation of some of the prospectuses and for certain supplementary disclosure items that were required under local law in some offering jurisdictions. As issuer of the shares that were offered, we became subject to the prospectus liabilities, if any, associated with its registering or listing the securities offered in various jurisdictions. The underwriting agreement provides that its underwriter indemnification provisions are in addition to, and do not affect, any liability that we, KfW, the Federal Republic or the underwriters may otherwise have. For a description of pending litigation and an investigation relating to the global offering, see Item 8. Financial Information Litigation.

**Other Transactions**

We provide telecommunications services to numerous companies, mainly throughout Europe, in the ordinary course of business, including firms in which we hold an ownership interest and firms with which certain members of the Supervisory Board are affiliated. We also provide telecommunications services in the ordinary course of business to the members of our boards and to the Federal Republic and its agencies and instrumentalities (including corporations owned or controlled by or affiliated with the Federal Republic).

In May 2002, T-Systems CSM GmbH and matrix42 AG entered into an agreement for the provision of consulting services, under which T-Systems paid matrix42 AG approximately EUR 100,000 in 2002. This agreement was renewed in March 2003 for one year. Konrad F. Reiss, CEO of T-Systems and member of our Management Board, owns approximately 10% of the shares of matrix42 AG and was a member of matrix42 AG's supervisory board until 2002.

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**ITEM 8. Financial Information**

**CONSOLIDATED FINANCIAL STATEMENTS**

See Item 18. Financial Statements.

**EXPORT SALES**

See the notes to the financial statements for a discussion of the revenues of the group by geographic area.

**LITIGATION**

We and our subsidiaries are involved in a number of legal proceedings in the ordinary course of our business. In addition, proceedings involving alleged abuse of a market-dominant position by us and alleged antitrust violations are pending before competition and regulatory authorities. With respect to the pending proceedings before competition authorities see Item 4. Information on the Company Regulation.

**Securities and Corporate Law-Related Proceedings**

A number of purported class action lawsuits have been filed and consolidated in the United States District Court for the Southern District of New York by or on behalf of purported purchasers of our ADSs issued pursuant to a registration statement on Form F-3 filed with the Securities and Exchange Commission on May 22, 2000, and pursuant to a prospectus dated June 17, 2000, and purported purchasers of our ADSs during the period from June 19, 2000, to and including February 21, 2001. The operative complaint in these consolidated actions asserts claims against us and the former Chairman of our Management Board, and others, under U.S. federal securities statutes based on allegations that statements made in the registration statement and prospectus were materially false and misleading because we allegedly failed adequately to disclose detailed information relating to merger negotiations between us and VoiceStream Wireless Corporation, and allegedly overstated the value of our real estate portfolio. The Court has certified the action as a class action and defined the class to include all purchasers of our ADSs during the period from June 19, 2000, to and including February 21, 2001. The Court has ordered that all fact discovery in the U.S. class action suits is to be completed by October 31, 2003. The selling shareholder in the offering, Kreditanstalt fuer Wiederaufbau, has been dismissed from the action.

Purported purchasers of our shares sold pursuant to prospectuses dated May 28, 1999 and May 26, 2000 have filed approximately 260 lawsuits in Germany. These lawsuits allege that the book values we recorded for our real property portfolio were improperly established and maintained under German accounting principles. In many of these lawsuits, claims have also been made with respect to the VoiceStream transaction analogous to those made in the purported U.S. class action lawsuits described above. These lawsuits are pending before the District Court in Frankfurt am Main. It is too early for us to express a view of the possible outcome of the lawsuits. The presiding judge has issued a statement describing his preliminary view that it will be necessary to take evidence by obtaining an expert opinion. The presiding judge also stated that he is inclined to order a stay of the civil litigation until the prosecutorial investigation into the real estate matter has been resolved. The court will probably decide on the stay in the course of the next months. The aggregate euro amount of all shareholders claims filed in Germany in these lawsuits is EUR 9,239,396.85.

We are contesting each of the aforementioned lawsuits vigorously. Because the lawsuits, which in the aggregate involve substantial damage claims, are in their preliminary stages, and the plaintiffs in the U.S. class action suits have not quantified the amount of damages they will seek, we are not in a position to predict their outcome or impact. However, we believe that the allegations in the lawsuits do not provide a basis for the recovery of damages because all required disclosures were made on a timely basis.

On June 26, 2000, two of our shareholders filed a suit with the District Court in Bonn (*Landgericht Bonn*) seeking to have declared void the shareholders resolutions authorizing both the stock option plan and a related conditional capital increase. The case was dismissed by the District Court in Bonn (*Landgericht Bonn*) on February 20, 2001. The Higher Regional Court in Cologne (*Oberlandesgericht Koeln*) dismissed the appeal

against this decision. On February 4, 2002, plaintiffs lodged an appeal on points of law with the Federal Court of Justice (*Bundesgerichtshof*).

On October 21, 1999, T-Mobile commenced arbitration proceedings in Vienna, Austria, against Elektrim S.A. and certain small shareholders of PTC. T-Mobile's claim alleges that these companies wrongfully failed to recognize our rights of first refusal over approximately 3% of PTC, and that this failure was a material



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breach of the PTC shareholder's agreement. These companies have denied T-Mobile's claim, and Elektrim has filed a counterclaim against T-Mobile alleging that T-Mobile materially breached the shareholders' agreement by, among other things, attempting to purchase PTC shares from several small shareholders and obstructing Elektrim's purchase of PTC shares. T-Mobile has denied the allegations made in the counterclaim. A finding by the arbitration panel that a party has materially breached the PTC shareholders' agreement would give the non-defaulting party the right to acquire the defaulting party's PTC shares at book value, which would be substantially below their current fair market value. In December 2000, T-Mobile filed a second suit against Elektrim claiming that Elektrim breached the terms of the Deed of Foundation of PTC by transferring all but one share in PTC to Telco, a limited company under Polish law in which Elektrim has a shareholding of 49% and Vivendi S.A. a shareholding of 51%. In particular, T-Mobile claims that (i) the transfer of shares required approval by the Supervisory Board of PTC, (ii) the shareholder agreement permitted only the transfer of a party's entire interest and (iii) the consent of the Polish Ministry of Telecommunications to the transfer was required but not obtained.

On October 3, 2002, T-Mobile UK Ltd. (T-Mobile UK) commenced proceedings in London, United Kingdom, against its joint venture partners, Bluebottle UK Ltd. and Bluebottle Investments S.A. (which are both companies affiliated with the Virgin Group of companies) and also against the joint venture company itself, Virgin Mobile Telecoms Ltd. (Virgin Mobile). As part of the joint venture, T-Mobile UK is required to pay Virgin Mobile a lump sum per month for each Virgin Mobile customer. Virgin Mobile is required to pay T-Mobile UK a fee per minute used by its customers on the T-Mobile UK network. The complaint contained a number of allegations, including the right of T-Mobile UK to terminate the Joint Venture through a no-fault termination process. Virgin Mobile counter-claimed for payment of sums that Virgin Mobile claimed had been improperly withheld by T-Mobile UK in relation to Virgin Mobile customers who had not made an outbound call for a certain period of time. Virgin Group has filed a separate proceeding against T-Mobile UK seeking certain declarations that alleged breaches by T-Mobile UK of the Shareholders Agreements governing the joint venture arrangement have occurred and that the Virgin Group is consequently entitled to serve on T-Mobile UK a compulsory sale notice requiring it to sell its shares in Virgin Mobile to Virgin Group for a nominal sum. The Virgin Group statement of claim also asks for further or other relief and costs but no quantification of these has been made. On March 6, 2003, the High Court in London rendered a decision in the action filed by T-Mobile UK and the counter claim filed by Virgin Mobile and held, in relevant part, that T-Mobile UK did not have the right to terminate the joint venture arrangement, and that it was unreasonable to expect T-Mobile UK to continue to pay Virgin Mobile with respect to customers that have been inactive for a significant period. Accordingly, under the judgment, the joint venture arrangement continues, but T-Mobile UK's payment obligations with respect to Virgin Mobile inactive customers have been resolved in T-Mobile UK's favor. T-Mobile UK has not paid the payments claimed by Virgin Mobile in respect of inactive customers but appropriate financial provisions have been and continue to be made. Oral applications for leave to appeal were made on March 14, 2003 by both T-Mobile UK and Virgin Mobile but were declined. Those applications for leave to appeal are likely to be renewed before the Court of Appeal but T-Mobile UK is still assessing the full impact of both decisions and is in the process of determining whether or not to pursue the appeal of certain aspects of the ruling. The court will not hear the declarations action for alleged breach filed by the Virgin Group until late 2003.

Press reports from Germany indicate that private parties are considering or planning litigation against us, our management, Kreditanstalt fuer Wiederaufbau and/or the Federal Republic of Germany on the basis of allegations that, among other things, the prospectuses used in connection with the secondary offering of our shares conducted in May/June 2000 should have disclosed that we paid too high a price for our 1999 acquisition of One 2 One (today T-Mobile UK) and that the market price of our shares at the time of the offering was too high, based on our business plans and prospects. We believe our disclosure was appropriate and, if litigation is commenced, intend to contest it vigorously.

**Investigations**

As previously disclosed, the Bonn public prosecutor is conducting an investigation (*Ermittlungsverfahren*) into allegations in the press and elsewhere asserting that the book values we recorded for our real property portfolio and fixed assets in general, including technical equipment and machinery, have been improperly established and maintained under applicable accounting principles and so were substantially overvalued in our 1995 opening balance sheet and in later balance sheets. The Bonn public prosecutor has notified us that his investigation also goes into whether we underpaid our German corporate income and trade taxes because

amortization and depreciation were higher than they should have been as a result of the alleged overstatement. We believe that the book values of our fixed assets have been correctly presented in

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accordance with applicable accounting principles, and dispute allegations to the contrary. We have nonetheless been cooperating fully in the investigation and are interested in seeing it expeditiously resolved. According to press reports, the public prosecutor indicated in early 2003 that his investigation would also cover the allegations described in the preceding paragraph. We cannot offer assurances as to the timing or outcome of the prosecutor's investigation. We believe that the investigation is being conducted with regard to certain individuals and is not directed against our company. Adverse consequences for our company could follow if any of the individuals who are or who become the subject of the investigation were found to have violated the law.

The Bonn public prosecutor is also conducting other investigations. One investigation concerns alleged breaches of duty by members of the Supervisory Board and past and present members of the Management Board with regard to our 2001 stock option program, the issuance of stock options and other management compensation arrangements with the Management Board, benefits paid or to be paid to our former Management Board chairman in connection with his withdrawal from the company and other circumstances of his withdrawal. Another investigation concerns allegations that members and former members of our Management Board breached their duties by causing us to pay excessive consideration for VoiceStream and Powertel. We understand both of these investigations are being conducted with respect to individuals and are not directed against us as a corporate entity. In each case, we believe that our board members and we acted appropriately. Adverse consequences for us could follow from these investigations, however, if the individuals who are the subjects of the investigations, are found to have violated the law. We are cooperating in the investigations.

The Bonn public prosecutor is further investigating allegations in the press and elsewhere asserting that we are involved in systematic wrongful billing. We have denied these allegations, but have been cooperating fully in the investigation and are interested in seeing it expeditiously resolved. We cannot offer assurances as to the timing or outcome of the prosecutor's investigations.

We understand that the Bonn public prosecutor's investigation into whether we impermissibly bore certain costs associated with the June 2000 global offering by KfW of our shares has been concluded without action.

## **Proceedings against Decisions of the German Telecommunications Regulator**

### **Wholesale Markets**

#### ***Interconnection***

The German telecommunications regulator issued decisions in 1997 and 1999 establishing the rates applicable to voice telephony interconnection services which we provided from January 1, 1998, through December 31, 1999, and from January 1, 2000, through January 31, 2001, respectively. We filed complaints against these decisions with the Cologne Administrative Court claiming higher rates. The proceedings are still pending.

In 2000, the German telecommunications regulator issued an order establishing a new tariff structure for interconnection, replacing the primarily distance-based tariff structure with an element-based tariff structure. We filed a complaint against this order and asked the courts for an injunction. In December 2000, the Cologne Administrative Court granted the requested injunction. The German telecommunications regulator applied for permission to appeal. The Appellate Administrative Court in Muenster rejected the appeal in May 2001. In the main action, the Cologne Administrative Court decided in our favor. One of our competitors, Arcor, has appealed the decision. The proceedings in the main action are still pending.

In 2001, the German telecommunications regulator issued a decision on the charges for interconnection, replacing the distance-based tariff-structure with an element-based tariff-structure. Certain of our competitors and we filed complaints and requests for injunction with the Cologne Administrative Court. The motions for injunctions were rejected. The proceedings in the main action are still pending.

In 2000, the German telecommunications regulator imposed upon us the obligation to offer Internet service providers and other enterprises demanding Internet access at a flat-rate to our fixed-line network by February 1, 2001.

Additionally, the German telecommunications regulator barred us from charging different rates for peak or off-peak connections outside the scope of the required flat rate. We filed a complaint against this decision and asked the court for an injunction. The Appellate Administrative Court in Muenster granted the injunction. The proceedings in the main action are still pending.

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In June 2002, the German telecommunications regulator imposed upon us the obligation to offer a wholesale flat rate for connections to Internet platforms. We asked the Cologne Administrative Court for an injunction against this decision and filed a complaint in the main action. The court granted the injunction. The German telecommunications regulator and a competing platform provider have appealed this decision. The Appellate Administrative Court in Muenster rejected the appeal. The proceedings in the main action are still pending.

### ***Local Loop***

In 1997, the German telecommunications regulator required us to offer certain competitors unbundled access to end customer lines ( local loop ). We asked the courts for an injunction and filed a complaint in the main action. In 1997 we agreed to comply with the subject requirement to the final decisions in the main proceedings. In 2001, the Federal Administrative Court (*Bundesverwaltungsgericht*) decided that we are obliged to offer unbundled access to certain competitors.

In 1998, the German telecommunications regulator issued a decision establishing the rates for access to the local loop (the monthly rate for the main option was DM 20.65 plus VAT), thereby rejecting our application and cost calculations. We filed a complaint against this order with the Cologne Administrative Court claiming higher rates. The proceedings are still pending.

In 1999, the German telecommunications regulator issued a decision adjusting the rates for access to the local loop provided from April 1, 1999, through March 31, 2001 (the monthly rate for the main option was DM 25.40 plus VAT). Certain of our competitors and we filed complaints against this decision with the Cologne Administrative Court. Dispute arose as to whether and to what extent our business secrets disclosed to the German telecommunications regulator may also be disclosed to the competitors taking part in the proceedings. The final decision on the question of disclosure is pending with the Federal Administrative Court. The proceedings in the main action are still pending.

In 2001, the German telecommunications regulator issued a decision adjusting the rates for access to the local loop from April 1, 2001, through March 31, 2003 (the monthly rate for the main option was DM 24.40 plus VAT). Certain of our competitors and we filed complaints against this decision with the Cologne Administrative Court in April 2001. The proceedings in the main action are still pending.

In July 2002, the German telecommunications regulator imposed upon us the obligation to modify our contractual conditions for the provision of access to the local loop. We are required, among other things, to include in our contracts clauses requiring us to pay penalties in cases of delays. We asked the courts for an injunction and filed a complaint. The Cologne Administrative Court granted an injunction. The German telecommunications regulator has appealed the decision. The appeal and the proceedings in the main action are still pending.

### ***Leased Lines***

In March and May 2002, the German telecommunications regulator imposed upon us the obligation to modify the contractual conditions for the provision of leased lines. We are required among other things, to include in our contracts clauses requiring us to pay penalties in case of delays, to expand our wholesale supply, and to warrant certain delivery periods. We asked the courts for an injunction and filed a complaint. The Cologne Administrative Court granted an injunction. The German telecommunications regulator has appealed the decision. The Appellate Administrative Court in Muenster rejected the appeal in essence. The proceedings in the main action are still pending.

### ***Resale***

In 1999, the German telecommunications regulator decided that rates for resale services (local calls, regional calls and long-distance calls) we offered to other telecommunications service providers are subject to regulatory approval. We asked the courts for an injunction and filed a complaint. The Appellate Administrative Court in Muenster granted the injunction. The proceedings in the main action are still pending.

In 2001, the German telecommunications regulator imposed upon us the obligation to offer certain resale services, including subscriber lines, local calls and city calls, to certain competitors. We asked the courts for an injunction and filed a complaint. The request for an injunction was rejected in result, but the Appellate Administrative Court in Muenster specified some important limitations on the imposed obligation. The proceedings in the main action are still pending.

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### ***Billing and Collection***

In 2000, the German telecommunications regulator imposed upon us the obligation to continue providing billing and collection services to certain competitors providing their services to our fixed-line customers. The affected services included call-by-call services, preselection services, certain value-added services, Internet-by-call services and directory assistance services. We asked the courts for an injunction and filed a complaint. The request for an injunction was rejected. In the main action, the Cologne Administrative Court decided partly in our favor by excluding value-added services, Internet-by-call services and directory services from the obligation. The German telecommunications regulator and one competitor have appealed the decision before the Appellate Administrative Court in Muenster. The proceedings in the main action are still pending. In addition, one of our competitors filed a complaint in the main action claiming that we were also obliged to manage customer complaints, to send late payment warnings and to enforce late payments. The Cologne Administrative Court rejected this complaint. The competitor has appealed the decision. The proceedings are still pending.

### ***Obligation to Service Provision Without Approved Rates***

In 2001, the German telecommunications regulator imposed upon us the obligation to provide certain wholesale services (access to the local loop) even without the regulatory approval of the respective rates. We asked the courts for an injunction and filed a complaint. The Appellate Administrative Court in Muenster granted the requested injunction. The proceedings in the main action are still pending.

### ***Retail Markets***

In 2001, the German telecommunications regulator decided that rates for external telecommunications of closed user group members are subject to regulatory approval. We asked the courts for an injunction and filed a complaint in the main action. The Cologne Administrative Court granted the requested injunction, which was affirmed by the Appellate Administrative Court in Muenster. The proceedings in the main action are still pending.

In December 2002, the German telecommunications regulator imposed upon us the obligation to raise our rates contractually agreed with two closed user groups. We asked the courts for an injunction and filed a complaint in the main action. The Cologne Administrative Court granted the requested injunction. The German telecommunications regulator can appeal this decision. The proceedings in the main action are still pending.

### **Other Proceedings**

In the first quarter of 2000, AOL Bertelsmann brought preliminary injunction proceedings and filed a complaint against T-Online and us before the Hamburg District Court (*Landgericht Hamburg*) claiming that T-Online had engaged in an anti-competitive practice by bundling its By-Call Internet access charge with our ISDN telephone access. The Hamburg District Court decided in our favor in both proceedings. AOL Bertelsmann's appeal to the Hamburg Court of Appeals was rejected. AOL Bertelsmann lodged an appeal with the German Federal Court of Justice (*Bundesgerichtshof*) that is still pending.

In September 1998, Deutsche Post AG commenced an arbitration proceeding seeking contributions from us relating to the cost of employee housing for former Deutsche Bundespost employees, including a number of our employees. In 1995, responsibility for the housing of former employees of Deutsche Bundespost was assigned to Deutsche Post AG. The parties have different views as to the amount we are obliged to pay as cost reimbursement for the use of such employee housing for our employees. Deutsche Post AG currently is seeking payment in the amount of EUR 114 million from us, although we expect that Deutsche Post AG may claim further amounts in the event that its initial claim is successful. In March 2000, we raised counterclaims in the amount of EUR 62.6 million reclaiming down payments from 1995 and 1996. The outcome of the arbitration proceeding is uncertain.

The complaint filed by World Access, Inc. in the U.S. District Court for the Northern District of Georgia asserting claims for alleged damages was dismissed for failure to effect timely service of the complaint.

Media reports have suggested that radio frequency emissions from wireless handsets and cell sites may raise various health concerns, including cancer, and may interfere with various electronic medical devices, including hearing aids and pacemakers. Research and studies are ongoing. Whether or not such research or studies conclude there is a link between radio frequency emissions and health, these concerns over radio frequency emissions may discourage the use of wireless handsets and may result in significant restrictions on



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the location and operation of cell sites, either or both of which could have a material adverse effect on our or on T-Mobile USA's results of operations. T-Mobile USA is subject to current, and potentially future, litigation relating to these health concerns. Several amended class action lawsuits have been filed against T-Mobile USA and several other wireless service operators and wireless phone manufacturers, asserting products liability, breach of warranty and other claims relating to radio frequency transmissions to and from wireless handsets. The complaints seek substantial money damages as well as injunctive relief. The defense of these lawsuits may divert management's attention, and T-Mobile USA may be required to pay significant awards or settlement and may incur significant expenses in defending these lawsuits. In addition, T-Mobile USA could be subject to potential litigation, legislation or adverse publicity relating to damage caused by persons who use mobile telephones while driving.

In April 2001, QPSX Europe GmbH filed suit for a permanent injunction with the District Court in Munich (*Landgericht Munich*) against us and Siemens AG, alleging that we are both infringing on plaintiff's patent by providing services using Asynchronous Transfer Mode (ATM) technology. Since ATM technology is used in a number of products and services that we offer, e.g. T-DSL and T-ATM, an adverse outcome in this proceeding could have a substantial adverse effect on our business.

T-Mobile USA and a joint venture in which T-Mobile USA holds an interest were both high bidders for certain U.S. mobile telecommunications licenses in FCC Auction No. 35. Most of those licenses had been repossessed and reaucted by the FCC after the original purchaser of the licenses declared bankruptcy. The original purchaser of those licenses challenged the FCC's repossession of the licenses in court and ultimately prevailed. Consequently, the FCC released all bidders including T-Mobile USA as well as the aforementioned joint venture from the obligation to purchase these spectrum licenses and granted a full refund of the deposits. The FCC's decision eliminated significant contingent liabilities to which T-Mobile USA was then subject, and resulted in the return of significant funds that had been held by the U.S. Government without interest for over one year.

In January 2002, the telecommunications carrier Global Crossing filed for bankruptcy protection. Previously, we had purchased from Global Crossing indefeasible rights to use certain network infrastructure in Western Europe that had a carrying value as of December 31, 2001, of less than EUR 300 million. The United States Bankruptcy Court has since approved Global Crossing's plan of reorganization as well as a joint stipulation filed by Global Crossing and us in which Global Crossing assumes the contracts pursuant to which we have acquired the indefeasible rights of use. Subject to Global Crossing's receipt of certain U.S. government approvals for aspects of its plan of reorganization, we expect the plan to become effective, thereby ending the uncertainty regarding the indefeasible rights of use. If for any reason the plan does not become effective and we become unable to avail ourselves of our indefeasible rights of use, we likely would need to incur costs to secure alternative capacity in the market.

**DIVIDEND POLICY**

The following table sets forth the annual dividends paid per share in respect of each of the financial years indicated. The dividends are paid during the year following the year with respect to which they relate.

For the year ended December 31,	Dividend Paid per Ordinary Share		
	DM	EUR	USD <sup>(1)</sup>
1998	1.20		0.64
1999		0.62	0.58
2000		0.62	0.53
2001		0.37	0.34

(1) Dividend amounts have been converted into dollars at the Noon Buying Rate for the relevant dividend payment date, which occurred during the second quarter of the following year.

To support our debt reduction efforts, the Supervisory Board and the Management Board have recommended to our shareholders that a dividend in respect of the 2002 fiscal year be omitted. Our shareholders will make a final decision on this recommendation at the annual general shareholders meeting scheduled for May 2003.

Shareholders determine the declaration, amount and timing of dividends based on our year-end unconsolidated stand-alone financial statements of Deutsche Telekom AG in respect of each year at their

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annual general meeting in the following year, upon the joint recommendation of the Management Board and the Supervisory Board.

Due to the completion of the Deutsche Telekom/ VoiceStream merger and the Deutsche Telekom/ Powertel merger in 2001, the Federal Republic and KfW no longer own a majority of our voting share capital. However, because approval of dividend distributions requires only a majority of votes present at a shareholders' meeting, the Federal Republic and KfW may be able to determine the level of dividends even though their combined interests in our shares have fallen below 50%. We may declare and pay dividends only from the distributable balance sheet profits (*Bilanzgewinn*) of Deutsche Telekom AG, as determined under German GAAP and as adjusted to reflect losses or gains carried over from prior years as well as transfers to or from retained earnings. Deutsche Telekom AG's retained earnings in its unconsolidated, stand-alone financial statements as of December 31, 2002 were EUR 7.0 billion, as compared to EUR 8.1 billion at the end of 2001. Certain reserves (*Ruecklagen*) are required by law to be made and deducted in calculating distributable balance sheet profits available for distribution as dividends.

The payment of future dividends depends on our earnings, our financial condition and other factors, including cash requirements, our future prospects and tax, regulatory and other legal considerations. We currently expect that substantial progress will need to be made on our debt reduction program before our Supervisory Board and Management Board will recommend the recommencement of dividend payments.

**SIGNIFICANT CHANGES**

Except as discussed elsewhere in this Annual Report, no significant change has occurred since the date of the annual financial statements included in this Annual Report.

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**ITEM 9. The Offer and Listing**

**TRADING MARKETS**

The principal trading market for our shares is the Frankfurt Stock Exchange. The shares also trade on the other German stock exchanges in Berlin, Bremen, Duesseldorf, Hamburg, Hanover, Munich and Stuttgart and on the Tokyo Stock Exchange. Options on the shares trade on the German options exchange (*Eurex Deutschland*) and other exchanges. Originally, we issued all our shares in bearer form. With effect from January 24, 2001, the shares were converted from bearer form to registered form.

American Depositary Shares ( ADSs ), each representing one share, are listed on the New York Stock Exchange (NYSE) and trade under the symbol DT. Deutsche Telekom ADSs are also traded on the Frankfurt Stock Exchange under the title DT Telekom ADR. The depository for the ADSs is Citibank N.A. For information on our ADR holders in the United States, see Trading on the New York Stock Exchange below.

**Trading on the Frankfurt Stock Exchange**

Deutsche Boerse AG operates the Frankfurt Stock Exchange, which is the most significant of the eight German stock exchanges. It accounts for the vast majority of the turnover in exchange-traded shares in Germany. As of December 31, 2002, the shares of 5,768 companies traded on the official, regulated and unregulated markets and the Neuer Markt Segment of the Frankfurt Stock Exchange. Of these, 867 were German companies and 4,901 were non-German companies.

Trading on the floor of the Frankfurt Stock Exchange begins every business day at 9:00 a.m. and ends at 8:00 p.m., Central European Time. Securities listed on the Frankfurt Stock Exchange generally trade in the auction market, but also change hands in interbank dealer markets both on and off the Frankfurt Stock Exchange. Publicly commissioned stockbrokers who are members of the Frankfurt Stock Exchange, but who do not as a rule deal with the public, note prices, which are determined by out-cry. The prices of actively traded securities, including the shares of large corporations, are continuously quoted during trading hours.

Our shares are traded on Xetra (Exchange Electronic Trading) in addition to being traded on the auction market. Xetra is an electronic exchange trading platform. Xetra is available daily between 9:00 a.m. and 8:00 p.m. to brokers and banks that have been admitted to Xetra by the Frankfurt Stock Exchange. Private investors can trade on Xetra through their banks or brokers.

Deutsche Boerse publishes a daily list of quotations containing the Xetra prices for all traded securities. The list is available on the Internet at <http://www.exchange.de> under the heading Market Data Price Overview.

Transactions on the Frankfurt Stock Exchange (including transactions through the Xetra system) settle on the second business day following the trade. Transactions off the Frankfurt Stock Exchange (such as, for example, large trades or transactions in which one of the parties is foreign) generally also settle on the second business day following the trade, although the parties may agree to a different period. Under standard terms and conditions for securities transactions employed by German banks, customers orders for listed securities must be executed on a stock exchange unless the customer gives specific instructions to the contrary.

The Frankfurt Stock Exchange can suspend a quotation if orderly trading is temporarily endangered or if a suspension is deemed to be necessary to protect the public.

The trading supervisory offices (*Handelsueberwachungsstellen*) at the stock exchanges and the exchange supervisory authorities (*Boersenaufsichtsbehoerden*) of the German federal states monitor trading activities on the German stock exchanges. The Federal Agency for Financial Services Supervision (*Bundesanstalt fuer Finanzdienstleistungsaufsicht*) monitors compliance with the insider trading rules.



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The table below sets forth, for the periods indicated, the high and low closing sales prices for our shares on the Frankfurt Stock Exchange, as reported by the Frankfurt Stock Exchange Xetra trading system, together with the highs and lows of the DAX (*Deutscher Aktienindex*).

	Price Per Ordinary Share		DAX <sup>(1)</sup>	
	High	Low	High	Low
(euro) <sup>(2)</sup>				
Yearly highs and lows				
1998	28.617	15.947	6,171.43	3,896.08
1999	71.00	31.35	6,958.14	4,678.72
2000	103.50	31.48	8,064.97	6,200.71
2001	38.75	14.50	6,795.14	3,787.23
2002	20.16	8.42	5,462.55	2,597.88
Quarterly highs and lows				
2001				
First Quarter	38.75	24.15	6,795.14	5,388.02
Second Quarter	30.30	23.30	6,278.90	5,553.46
Third Quarter	27.56	14.50	6,109.50	3,787.23
Fourth Quarter	20.50	16.50	5,271.29	4,239.97
2002				
First Quarter	20.16	15.00	5,462.55	4,745.58
Second Quarter	17.12	8.59	5,343.88	4,099.05
Third Quarter	12.60	8.42	4,883.03	2,769.03
Fourth Quarter	13.26	8.74	3,380.20	2,597.88
Monthly highs and lows				
2002				
October	11.64	8.74	3,282.67	2,597.88
November	12.40	10.72	3,360.76	3,042.06
December	13.26	12.01	3,380.20	2,840.00
2003				
January	14.49	11.91	3,476.83	2,836.01
February	13.24	10.00	2,802.93	2,433.15
March	11.20	9.04	2,731.57	2,188.75
April (through April 11, 2003)	12.09	10.33	2,809.94	2,450.19

(1) The DAX is a weighted performance index of the shares of thirty large German corporations. The calculation of the DAX did not change upon the introduction of the euro. The composition of the DAX and the weighting of different corporations in the DAX has changed in the period covered by this table and may change in the future. Because a significant number of institutional investors adjust their stock portfolios to correspond to the composition of important stock indices, changes in the weighting of Deutsche Telekom shares in these indices have led to fluctuations in our share price in the past and could cause similar fluctuations in the future.

(2) Effective January 1, 1999, Germany and ten other member states of the European Union adopted the euro as their common currency. From January 4, 1999, all shares on German stock exchanges have traded in euros. For consistency of presentation, we have converted amounts in Deutsche Marks for prior periods into euros at the official fixed conversion rate of EUR 1.00 = DM 1.95583. The conversion of all Deutsche mark amounts into euros at the official fixed conversion rate does not affect the trends discussed above. However, the amounts appearing above for dates or periods prior to January 4, 1999, will not be comparable to share prices for other companies to the extent that those prices were denominated in a currency other than the Deutsche mark.

On March 31, 2003, the closing sales price per ordinary share on the Frankfurt Stock Exchange was EUR 10.11, which was equivalent to USD 11.02 per share, converted into U.S. dollars using the noon buying

rate in New York City for cable transfers in euros as certified for customs purposes by the Federal Reserve Bank of New York for March 31, 2003. On March 31, 2003, the noon buying rate was 1.0900 U.S. dollar per euro.

**Table of Contents****Trading on the New York Stock Exchange**

American Depositary Shares (ADSs), each representing one of our ordinary shares, are listed on the New York Stock Exchange and trade under the symbol DT. The depository for the ADSs is Citibank N.A.

The table below sets forth, for the periods indicated, the high and low closing sales prices for our ADSs on the NYSE:

	Price per ADS	
	High	Low
	USD	
Yearly highs and lows		
1998	33 1/2	17 1/16
1999	71	36 1/16
2000	98 5/8	29 1/4
2001	36.56	13.39
2002	18.01	8.27
Quarterly highs and lows		
2001		
First Quarter	36.56	22.11
Second Quarter	26.76	19.50
Third Quarter	23.12	13.39
Fourth Quarter	18.14	15.08
2002		
First Quarter	18.01	13.15
Second Quarter	15.15	8.58
Third Quarter	12.49	8.27
Fourth Quarter	13.52	8.35
Monthly highs and lows		
2002		
October	11.55	8.35
November	12.47	10.77
December	13.52	12.06
2003		
January	15.19	12.13
February	14.13	10.85
March	11.87	9.95
April (through April 11, 2003)	12.68	11.30

On March 31, 2003, the closing sales price per ADS on the NYSE was US\$11.02.

Based on the share register, as of March 31, 2003, we had approximately 2,773,889 registered holders of our ordinary shares, including holders of record of our shares with addresses in the U.S.

As of March 31, 2003, there were 159,553,284 of our ADSs outstanding, with 1,533 holders of record of our ADSs with addresses in the United States and 60 holders of record of ADSs with addresses outside the United States.



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### **ITEM 10. Additional Information**

#### **ARTICLES OF ASSOCIATION**

This Item provides is a summary of certain information relating to our share capital and of certain provisions of our Articles of Association and German law. This summary is not complete and is qualified by reference to our Articles of Association and German law as in effect at the date of this filing. Copies of the Articles of Association are publicly available at the Commercial Register in Bonn, and an English translation has been filed as an exhibit to this Annual Report on Form 20-F.

#### **Organization and Register**

We are a stock corporation organized in the Federal Republic of Germany under the German Stock Corporation Act (*Aktiengesetz*). We are registered in the Commercial Register (*Handelsregister*) maintained by the local court in Bonn, Germany, under the entry number HRB 6794.

#### **Purpose and Object of Deutsche Telekom AG**

According to our Articles of Association, our object is activity in all areas of telecommunications, information technology, multimedia, information and entertainment, as well as security services and any service connected to these areas and also in related areas in Germany and abroad. We are entitled to enter into all other transactions and take all other measures deemed appropriate to serve the object of the enterprise. We may also set up, acquire and participate in other undertakings of the same or similar kind in Germany and abroad, as well as run such undertakings or confine itself to the administration of its participations. We may spin off our operations wholly or partly to affiliated undertakings, provided, that applicable legal requirements, such as requisite shareholder resolutions, are satisfied.

#### **Information relating to Supervisory Board and Management Board Members**

Pursuant to the German Stock Corporation Act, a Supervisory Board member may not receive a loan from us unless approved by the Supervisory Board. A Management Board member may only receive a loan from us upon prior approval by the Supervisory Board. We do not make loans to our Supervisory Board or Management Board members. For further information with respect to the Supervisory Board and the Management Board, see also Item 6. Directors, Senior Management and Employees.

#### **Class of Stock**

Our capital stock consists of ordinary shares in registered form with no par value (*Stueckaktien*). The individual shares do not have a par value as such, but they do have a notional par value that can be determined by dividing the share capital amount by the number of shares.

Prior to January 24, 2000, these shares were issued only in bearer form. At their annual meeting held on May 27, 1999, the shareholders of Deutsche Telekom approved the conversion of all the shares of Deutsche Telekom from bearer form to registered form. This resolution was filed for registration with the commercial register, and all ordinary shares of Deutsche Telekom were issued in registered form upon registration of the resolution in January 2000.

#### **Authorized Capital**

At the shareholders' general meeting on May 25, 2000, an amendment to the Articles of Association was approved that created authorized capital of up to EUR 3,865,093,163.52 for the issuance of up to 1,509,802,017 shares. That authorization was used to the extent of EUR 2,990,459,880.96 for the issuance of new shares to effect the acquisition of T-Mobile USA (formerly VoiceStream) and Powertel in 2001.

**Conditional Capital**

The shareholders' general meeting on May 29, 2001 resolved upon a conditional capital authorizing our Board of Management to increase the capital stock by up to EUR 500,000,000, divided into up to 195,312,500 shares (Contingent Capital I) to the extent that:

the holders or creditors of conversion rights or warrants attached to the convertible bonds or bonds with warrants issued by May 28, 2006 by Deutsche Telekom AG or a company in which it has a direct or indirect majority holding on the basis of the authorization granted by resolution of the Shareholders Meeting of May 29, 2001, exercise their conversion or option rights or

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holders or creditors obligated to convert the convertible bonds issued by May 28, 2006, by Deutsche Telekom AG or companies in which it has a direct or indirect majority holding pursuant to the authorization granted by resolution of the Shareholders Meeting of May 29, 2001, fulfill their conversion obligation.

The new shares participate in profits starting at the beginning of the financial year in which they are issued as the result of the exercise of any conversion or option rights being exercised or the fulfillment of any conversion obligations.

In March 2003, approximately EUR 2.3 billion of convertible bonds were issued out of this conditional capital. The bonds are mandatorily convertible into common shares of Deutsche Telekom AG at the latest at maturity on June 1, 2006. The bonds were issued by our Dutch finance subsidiary, Deutsche Telekom International Finance B.V., and guaranteed by Deutsche Telekom AG. The bonds were priced at par with a 6.5% coupon and a conversion ratio that, depending on the share price performance, may vary from a ratio of 3,417.1679 shares to 4,237.2881 shares for each bond (EUR 50,000 nominal amount). Except as is otherwise described in their terms and conditions, the bonds allow for voluntary conversion into common shares of Deutsche Telekom during the period from July 1, 2003 until April 30, 2006 at a conversion ratio that is equal to 3,417.1679 shares of the bonds. The bonds that remain outstanding on June 1, 2006 are then subject to the mandatory conversion.

The share capital also may be increased by up to EUR 307,200,000, divided into up to 120,000,000 new no par value registered shares (Contingent Capital II) for the purpose of granting subscription rights to members of the Board of Management of the Corporation, executives at levels below the Board of Management of the Corporation and other executives, managers and specialists of the Corporation and to Board of Management members, managing board members and other executives of second- and lower-tier domestic and foreign Group companies on the basis of a 2001 Stock Option Plan as provided for in the resolution of the Shareholders Meeting of May 29, 2001. It will be implemented only to such extent as subscription right holders make use of their subscription rights. The new shares participate in profits starting at the beginning of the financial year in which they are issued. If new shares are issued after the end of a financial year but before the Corporation's Shareholders Meeting that resolves regarding the appropriation of net income for the financial year ended, the new shares participate in the profits starting at the beginning of the financial year ended. For further information regarding stock-based compensation plans, including the numbers of options granted and exercised, exercise prices and expiration dates, refer to notes (26) and (40) to the consolidated financial statements.

In addition, the share capital may be increased by up to EUR 2,621,237.76, divided into up to 1,023,921 shares (Contingent Capital III) exclusively to grant subscription rights to members of the Board of Management and executives of the Corporation, as well as Board of Management members, managing board members and other executives of second- and lower-tier affiliated companies on the basis of a Stock Option Plan as provided for in the resolution of the Shareholders Meeting of May 25, 2000. It will be implemented only to such extent as use is made of those subscription rights. The new shares participate in profits starting at the beginning of the financial year in which they are issued. If new shares are issued after the end of a financial year but before the Corporation's regular Shareholders Meeting that resolves regarding the appropriation of net income for the financial year ended, the new shares participate in the profits starting at the beginning of the financial year ended. For further information regarding stock-based compensation plans, including the numbers of options granted and exercised, exercise prices and expiration dates, please refer to notes (26) and (40) to the consolidated financial statements.

## **Voting Rights and Shareholders Meetings**

Each share entitles its holder to one vote at our general meeting of the shareholders. Shareholders may pass resolutions at a general meeting by a majority of the votes cast, unless a higher vote is required by law or by our Articles of Association. Neither the German Stock Corporation Act nor the Articles of Association provide for minimum quorum requirements for shareholders meetings. The German Stock Corporation Act requires that significant resolutions be passed by a majority of the votes cast and with at least three-quarters of the share capital represented at a meeting.

These significant resolutions include:

capital increases which provide for an exclusion of preemptive rights;

capital decreases;

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the creation of authorized capital (*genehmigtes Kapital*) or conditional capital (*bedingtes Kapital*);

our dissolution;

our merger into or consolidation with another corporation;

split-off or spin-off pursuant to the German Transformation Act (*Umwandlungsgesetz*); transfer of all our assets;

conclusion of intercompany agreements (*Unternehmensvertraege*), including, in particular, control and profit transfer agreements (*Beherrschungs- und Gewinnabfuhrungsvertraege*);

amendments to the statement of corporate purpose in our Articles of Association; and

a change in our corporate form.

A general meeting of our shareholders may be called by the Management Board or by shareholders holding in the aggregate at least 5% of our issued share capital. If required in our interest, the Supervisory Board must call a shareholders' meeting. The annual general meeting must take place within the first eight months of the fiscal year and is called by the Management Board upon the receipt of the Supervisory Board's report on the annual financial statements. Under the Articles of Association, the right to participate in and to vote at a shareholders' meeting will only be given to those shareholders who have timely registered for the participation at the shareholders' meeting (either in person or represented by an agent) with the company and who are included in the share register when their registration for the shareholders' meeting is received. There must be at least six days between receipt of the registration and the date of the shareholders' meeting, unless the Management Board shortens the time period. Following receipt of a shareholder's registration, we will not enter a transfer of the related shares in the share register until after the conclusion of the general shareholders' meeting. We must publish notice of shareholders' meetings in the Federal Gazette (*Bundesanzeiger*) at least one month prior to the date by which shareholders have to register for the shareholders' meeting. The day of publication and the last date by which shareholders have to register for the shareholders' meeting are not counted for this purpose. In addition, we must publish a notice in a national authorized stock exchange journal.

Holders of shares (but not holders of ADSs) are required to provide to us their names, addresses and birth dates (or, in the case of business entities, their names, business addresses and registered seats) as well as the number of shares held, so that they can be entered into the share register maintained by us. ADEUS Aktienregister-Service-GmbH (a company not related to us) is the transfer agent and registrar of the registered shares in Germany.

## **Dividends and Other Distributions**

We may pay dividends immediately following the resolution by the general meeting of shareholders on the distribution of profits. Shareholders participate in profit distributions in proportion to their shareholdings.

Under German law, we may declare and pay dividends only from balance sheet profits as shown in the unconsolidated annual financial statements of Deutsche Telekom AG. In determining the distributable balance sheet profits, our Management Board and Supervisory Board may allocate to profit reserves (*andere Gewinnruecklagen*), either in whole or in part, the annual surplus (*Jahresueberschuss*) that remains after allocation to statutory reserves and losses carried forward. Under our Articles of Association, transferring more than one-half of the annual surplus to profit reserves is not permissible if, following the transfer, the accumulated reserves out of surplus would exceed one-half of our share capital. The shareholders, in determining the distribution of profits, may allocate additional amounts to profit reserves and may carry forward profits in part or in full. Our shareholders may also decide by resolution to pay dividends in kind if the assets to be distributed are such as can be traded on a market as defined by Article 3(2) German Stock Corporation Act.

Dividends approved at a shareholders' meeting are payable on the first stock exchange trading day after that meeting, unless otherwise decided at the shareholders' meeting. Details regarding paying agents are published in

the Federal Gazette (*Bundesanzeiger*). Shareholders holding ordinary shares through Clearstream Banking AG receive dividends by credit to their respective accounts.

**Record Dates**

In accordance with the German Stock Corporation Act, the record date for determining which holders of our ordinary shares are entitled to the payment of dividends, if any, or other distributions, whether in cash,

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stock or property, will be the date of the general meeting of shareholders at which such dividends or other distributions are declared. The record date for determining which holders of our ordinary shares are entitled to vote at a general meeting will be the date of such general meeting, provided that holders of our ordinary shares who are registered in the share register (*Aktienbuch*) on the date of the meeting will be entitled to attend and vote at the meeting only if such holders have given us notice of their desire to attend early enough that there are at least six days between the day the notice is given and the day of the shareholders' meeting, unless the Management Board shortens the time period.

### **German Requirements to Disclose Shareholdings**

The German Securities Trading Act (*Wertpapierhandelsgesetz*) requires each person whose shareholding reaches, exceeds or, after exceeding, falls below the 5%, 10%, 25%, 50% or 75% voting rights thresholds of a listed company to notify the company and the Federal Agency for Financial Services Supervision (*Bundesanstalt fuer Finanzdienstleistungsaufsicht*) in writing within seven calendar days after they have reached, exceeded or fallen below such a threshold. In their notification, they must, among other things, state the number of votes they have and the relative voting power that the number of shares they hold represent. Such holders cannot exercise any rights, including voting rights and the rights to receive dividends from those shares, until they have satisfied this disclosure requirement. Failure to notify may also trigger a penalty provided for by law. In addition, the German Securities Trading Act contains various rules designed to ensure the attribution of shares to the person who has effective control over the exercise of the voting rights attached to those shares.

Furthermore, the German Securities Trading Act now stipulates that any dealings by members of our Management Board or Supervisory Board or their close relatives in securities or derivatives of Deutsche Telekom AG must be disclosed to us and to the Federal Agency for Financial Services Supervision, if the dealings within a period of 30 days exceed a value of EUR 25,000, Deutsche Telekom AG is obligated to publish such dealings either on the Internet or in a national newspaper designated for stock exchange notices and then send proof of this publication to the Financial Services Supervisory Authority.

### **Repurchase of Shares**

Under the German Stock Corporation Act, we may not purchase our own shares, subject to certain limited exceptions.

Our general shareholders' meeting on May 28, 2002, approved a resolution that authorizes us to purchase our own shares in an amount representing up to 10% of our registered share capital through November 18, 2003. The purchase price for the shares (excluding purchasing costs) must not exceed or fall below the market price by more than 5%, in the case of a purchase on the stock exchange, or 20%, in the case of an offer to purchase made to all shareholders. The relevant market price for this purpose would be the opening auction price in the Xetra system of the Frankfurt Stock Exchange on the day of the purchase, in the case of a purchase on the stock exchange, or the closing price in the Xetra system on the day prior to the publication of the offer, in the case of an offer to purchase made to all shareholders.

Pursuant to the resolution, our Management Board is authorized, with the approval of the Supervisory Board, to:

- (1) list the acquired shares on foreign stock exchanges on which they are not listed;
- (2) offer the acquired shares to third parties in the context of mergers with and acquisitions of other companies and acquisitions of interests in other companies; and
- (3) cancel the acquired shares without further shareholder approval. This cancellation option can be exercised in whole or in part.

Shareholders' preemptive rights are excluded for the purposes listed in clauses (1) and (2) above. The price for any sale on a stock exchange or use in a merger or acquisition transaction would not be permitted to be more

than 5% below the opening auction price of our shares in the Xetra system of the Frankfurt Stock Exchange on the day of the sale on the stock exchange or the definitive agreement with a third party, as applicable.

**Preemptive Rights**

Under the German Stock Corporation Act, every shareholder generally has preemptive rights with respect to an issuance of new shares (including securities convertible into shares, securities with warrants to purchase



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shares, profit-sharing certificates and securities with a profit participation). Preemptive rights are freely transferable and may be traded on the German stock exchanges for a limited number of days prior to the final date for the exercise of the rights. Shareholders may exclude preemptive rights through a resolution passed by a majority of votes cast and a majority of at least three quarters of the share capital represented in the shareholders meeting. In addition, an exclusion of preemptive rights requires a report by the Management Board, which must justify the exclusion by establishing that our interest in the exclusion outweighs the shareholders' interest in exercising their preemptive rights. Preemptive rights related to the issuance of new shares may be excluded without justification if:

we increase share capital for cash contributions; and

the amount of the increase does not exceed 10% of the issued share capital; and

the shares are sold at a price not substantially lower than the current quoted share price.

## **Rights upon Liquidation**

In accordance with the German Stock Corporation Act, upon a liquidation of Deutsche Telekom AG, shareholders will receive, in proportion to the ordinary shares held, any liquidation proceeds remaining after paying off all of our liabilities.

## **Corporate Governance**

We are obligated under German law to declare compliance and non-compliance with the new German Corporate Governance Codex at least once per year. The relevant declaration and the text of the German Corporate Governance Codex are published in the English language on our Internet homepage accompanied by a short description of the German Corporate Governance concept.

## **MATERIAL CONTRACTS**

### **VoiceStream Acquisition**

On July 24, 2000 Deutsche Telekom entered into a contract with VoiceStream Wireless Corporation (now T-Mobile USA) that provided for VoiceStream to merge with and into a wholly-owned subsidiary of Deutsche Telekom AG. In connection with this merger, which closed in May 31, 2001 former VoiceStream shareholders received EUR 4.9 billion in cash and newly issued Deutsche Telekom shares having a market value on that date of approximately EUR 28.7 billion.

## **EXCHANGE CONTROLS**

At present, German law does not restrict the movement of capital between Germany and other countries or individuals, except with respect to investments in Iraq and with certain persons and entities associated with Osama bin Laden, the Al Qaida network and the Taliban and certain other countries and individuals subject to embargos in accordance with German law and applicable resolutions adopted by the United Nations and the European Union.

For statistical purposes, with certain exceptions, every corporation or individual residing in Germany must report to the German Central Bank (*Deutsche Bundesbank*) any payment received from, or made to or for the account of, a non-resident corporation or individual that exceeds EUR 12,500 (or the equivalent in a foreign currency).

At the end of every calendar month, corporations or individuals residing in Germany, must report to the German Central Bank any claims of a resident against, or liabilities payable to, a non-resident corporation or individual that in the aggregate exceed EUR 5 million (or the equivalent in foreign currency). Resident corporations and individuals are also required to report annually to the German Central Bank any stakes of 10% or more they hold in the equity of nonresident corporations with total assets of more than EUR 3 million.

Corporations residing in Germany with assets in excess of EUR 3 million must report annually to the German Central Bank any stake of 10% or more in the company held by an individual or a corporation located outside Germany.

**Table of Contents****TAXATION**

The following is a summary of the material U.S. federal income tax and German tax considerations relating to the ownership and disposition of our ADSs or shares by a U.S. Holder. In general, a U.S. Holder, as referred to here, is any beneficial owner of ADSs or shares (1) who is a resident of the United States for purposes of the income tax treaty between the United States and Germany, referred to here as the Treaty, (2) who is not also a resident of the Federal Republic of Germany for purposes of the Treaty, (3) who owns the ADSs or shares as capital assets, (4) who does not hold shares or ADSs as part of the business property of a permanent establishment or a fixed base in Germany, and (5) who is entitled to benefits under the Treaty with respect to income and gain derived in connection with the ADSs or shares.

**Each investor is strongly urged to consult his or her own tax advisers regarding the United States federal income and German tax consequences of the purchase, ownership and disposition of our ADS or shares in light of his or her particular circumstances, including the effect of any state, local, or other national laws.**

***German Taxation***

This summary is based on German tax laws as in effect on the date hereof and is subject to changes in German tax laws or treaties. This summary reflects the changes made by the German Tax Reduction Act (*Steuersenkungsgesetz*) applicable to us for fiscal years beginning January 1, 2001, and the changes introduced through the Act for the Further Development of Business Tax Law (*Gesetz zur Fortentwicklung des Unternehmenssteuerrechts*), effective as of January 1, 2002. Moreover, the Flood Victim Solidarity Act (*Flutopfersolidaritätsgesetz*), which was enacted in September 2002, will be applicable to us for the fiscal year beginning January 1, 2003.

***Taxation of the Company in Germany***

In general, German corporations are subject to German corporate income tax at a flat rate of 25%, regardless of whether such income is distributed or not. A solidarity surcharge of 5.5% is imposed on the net assessed corporate income tax liability, resulting in an aggregate effective German corporate income tax charge of 26.375%, which does not include German local trade tax. The corporate income tax rate was increased by the Flood Victim Solidarity Act enacted in September 2002. As a result of the new law, the German corporate income tax rate will increase from 25% to 26.5% for fiscal year 2003 only.

In addition, a German resident company is subject to profit-related trade tax, which is levied on our trade income. The effective rate of the trade tax depends on the rate set by each municipality where the company is resident. It generally ranges from 15 to 21%. In computing the income tax of a corporation, the trade tax on income is deductible as a business expense.

Under current legislation, losses generally can be accumulated for corporate income tax as well as for trade tax purposes. To the extent losses cannot be offset against taxable income, the remaining portion can be carried forward indefinitely. For corporate income tax purposes there is an optional carryback to the previous year of up to EUR 511,500.

***German Withholding Tax on Dividends***

The full amount of a dividend distributed by the company is generally subject to German withholding tax at the domestic rate of 20%, plus a solidarity surcharge of 5.5% (effectively 1.1% of the dividend before taxes) resulting in an aggregate rate of withholding of 21.1%.

From January 1, 2001, as a result of the German Tax Reduction Act, the abolition of the corporate income tax credit system eliminated certain benefits previously available to U.S. Holders under the Treaty.

***Other German Taxes***

No German transfer, stamp or other similar taxes apply to the purchase, sale or other disposition of shares or ADSs by a U.S. Holder. Currently, net worth tax is not levied in Germany.

*German Taxation of Bonus Shares*

The German tax authorities recently issued a release dated Dec. 13, 2002 stating that the receipt of bonus shares in January 2002 with respect to shares purchased in our third public offering in 2000 should constitute other taxable income within the meaning of Section 22 No. 3 German Income Tax Act

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(*Einkommensteuergesetz*). U.S. holders are therefore not subject to German income tax with respect to bonus shares received in connection with our third public offering. The German tax authorities will therefore treat the receipt of bonus shares in connection with the third public offering differently than the receipt of bonus shares in connection with the second public offering.

According to a release of the Federal Ministry of Finance dated December 10, 1999, bonus shares received in 2000 with respect to shares purchased in the second public offering in 1999 should be taxed as taxable dividend income to the shareholders although no withholding tax was to be retained.

However, the local tax court in Duesseldorf held in a recent ruling that the receipt of bonus shares should be treated as a purchase price adjustment for German tax purposes. This decision has been appealed and is now pending before the German federal tax court. Shareholders may consider appealing any German income tax assessment that treats the receipt of bonus shares as a taxable dividend.

### **Special Tax Rules for U.S. Holders**

This section applies only if you hold your shares or ADSs as capital assets for tax purposes. It does not address all material tax consequences of owning shares or ADSs. This section does not address special classes of holders that are subject to special rules, including:

tax-exempt entities;

life insurance companies;

dealers in securities;

traders in securities that elect a mark-to-market method of accounting for securities holdings;

investors liable for the alternative minimum tax;

investors that actually or constructively own 10% or more of our voting stock;

investors that hold shares or ADSs as part of a straddle or a hedging or conversion transaction; or

investors whose functional currency is not the U.S. dollar.

#### ***Imposition and Refund of German Withholding Tax***

Under the Treaty, a U.S. Holder will be entitled to claim a refund to the extent the amount withheld exceeds the 15% rate provided under the Treaty, but will not be entitled to the additional payment associated with 2001 dividends.

Accordingly, for a declared dividend of 100, a U.S. Holder initially will receive 78.9 (100 minus the 21.1% withholding tax). The U.S. Holder is then entitled to a partial refund from the German tax authorities in the amount of 6.1% of the gross dividend, which is equal to the difference between the amount withheld at the German domestic dividend withholding rate (plus solidarity surcharge) and the amount computed under the applicable treaty rate (21.1% aggregate German withholding tax minus 15% Treaty withholding tax rate). As a result, the U.S. Holder will effectively receive a total of 85 (i.e., 85% of the declared dividend). The U.S. Holder will be deemed to have received a dividend of 100, subject to German withholding tax of 15.

The gross amount of dividends that a U.S. Holder receives (prior to the deduction of German withholding tax), generally will be subject to U.S. federal income taxation as foreign source dividend income, and will not be eligible for the dividends received deduction generally allowed to U.S. corporations. German withholding tax at the 15% rate provided under the Treaty will be treated as a foreign income tax that, subject to generally

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applicable limitations under U.S. tax law, is eligible for credit against a U.S. Holder's U.S. federal income tax liability or, at the holder's election, may be deducted in computing taxable income. A U.S. Holder will not be able to claim credits for German taxes that would have been refunded if the holder had filed a claim for a refund. For foreign tax credit purposes, dividends we pay will be foreign source passive income or, in the case of certain U.S. Holders, financial services income. Foreign tax credits will not be allowed for withholding taxes imposed in respect of certain short-term or hedged positions in securities or in respect of arrangements in which a U.S. Holder's expected economic profit is insubstantial. U.S. Holders should consult their own advisers concerning the implications of these rules in light of their particular circumstances.

Dividends will be paid in euro and will be included in the income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate in effect on the date of receipt by the holder or, in the

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case of ADSs, by the depositary, regardless of whether the payment is in fact converted into U.S. dollars. If such a dividend is converted into U.S. dollars on the date of receipt, a U.S. Holder generally should not be required to recognize foreign currency gain or loss in respect of the dividend income. A U.S. Holder may be required to recognize foreign currency gain or loss on the receipt of a refund in respect of German withholding tax to the extent the U.S. dollar value of the refund differs from the U.S. dollar equivalent of that amount on the date of receipt of the underlying dividend.

***Taxation of Capital Gains***

Under the Treaty, a U.S. Holder will not be liable for German tax on capital gains realized or accrued on the sale or other disposition of shares or ADSs provided that the shares or ADSs subject to such transfer are not held as part of a permanent establishment or a fixed base in Germany.

For U.S. federal income tax purposes, gain or loss realized by a U.S. Holder on the sale or disposition of shares or ADSs will be capital gain or loss, and will be long-term capital gain or loss if the shares or ADSs were held for more than one year. The net amount of long-term capital gain recognized by an individual holder generally is subject to taxation at a maximum rate of 20%. A U.S. Holder's ability to offset capital losses against income is subject to limitations. Deposits and withdrawals of shares in exchange for ADSs will not result in the recognition of gain or loss for U.S. federal income tax purposes.

***German Inheritance and Gift Tax***

Under the estate tax treaty between the United States and Germany a transfer of shares or ADSs by gift or at death is generally not subject to German inheritance or gift tax, if the donor or the transferor is domiciled in the United States. However, this does not apply if the heir, donee or other beneficiary is domiciled in Germany. In this case, the transferred shares or ADSs are subject to German inheritance or gift tax. However, the amount of federal estate tax paid in the United States with respect to the transferred shares or ADSs will be credited against the German inheritance or gift tax liability pursuant to the estate tax treaty.

***Bonus Shares***

Certain holders who acquired shares or ADSs at the time they were offered in our third public offering in 2000 were entitled to receive bonus shares if they continued to hold their shares or ADSs up to a specified date. The receipt of bonus shares will be treated differently for U.S. and German tax purposes. From a U.S. tax perspective, the receipt of bonus shares should be treated as a purchase price adjustment. Accordingly, U.S. Holders would not include any amount in income upon the receipt of bonus shares, and instead would reallocate their tax basis between the prior shareholding and the bonus shares.

Because the German tax authorities now take the view that the receipt of the bonus shares with respect to our third public offering constitutes other taxable income within the meaning of Section 22 No. 3 German Income Tax Act, U.S. Holders are not subject to German income tax with respect to these particular bonus shares. For further information, see *German Taxation of Bonus Shares* above.

The German tax authorities currently treat the receipt of bonus shares with respect to our second public offering as a taxable dividend. Although the delivery of bonus shares was not subject to German withholding tax, a recipient who is a U.S. Holder would in principle still be liable for German tax at the 15% rate applicable to dividend income under the Treaty. A U.S. Holder must therefore file a tax return and report this income to the German tax authorities. For further information, see *German Taxation of Bonus Shares* above. For purposes of the U.S. foreign tax credit limitation, it is possible that any German taxes paid with respect to bonus shares may be allocated to general limitation income. In that event, a U.S. Holder who does not receive sufficient foreign-source general limitation income from other sources may not be able to derive effective foreign tax credit benefits in respect of those German taxes.

In the case of a U.S. Holder's sale or other disposition of the bonus shares or ADSs representing such bonus shares, the rules described above under *Taxation of Capital Gains* apply.

*Refund Procedures for U.S. Holders*

Pursuant to administrative procedures introduced on a trial basis (and which therefore could be amended or revoked at any time), a simplified collective refund procedure currently is available to certain U.S. Holders of ADSs that are held through brokers participating in the Depository Trust Company ( DTC ). Under these procedures, DTC provides the German tax authorities with electronic certification of the U.S. taxpayer status of such U.S. Holders based on information it receives from its broker participants, and collectively claims a



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refund on behalf of those U.S. Holders. This combined claim need not include evidence of a U.S. Holder's entitlement to Treaty benefits. The German tax authorities will issue refunds on a preliminary basis to DTC, which in turn will issue corresponding refund checks to the participating brokers. Under audit procedures that apply for up to four years, the German tax authorities may require brokers to provide evidence regarding the entitlement of their clients to Treaty benefits. In the event of such an audit, brokers must submit to the German tax authorities a list containing names and addresses of the relevant holders of ADSs, and official certifications on IRS Form 6166 of the last filed United States federal income tax returns of such holders (discussed below). Brokers participating in the DTC arrangements may require that holders provide documentation establishing their eligibility for Treaty benefits.

Claims for Treaty refunds by U.S. Holders of ADSs who do not participate in the DTC procedures discussed above may be submitted to the German tax authorities by the depositary on behalf of those holders. Holders who are entitled to refunds in excess of EUR 153.39 for the calendar year normally must file their refund claim on an individual basis; however, the depositary may be in a position to make a refund claim on behalf of such holders. Details of the refund procedures for holders of ADSs can be obtained from the depositary.

If a U.S. Holder does not submit a claim for a Treaty refund pursuant to the collective refund procedures described above, then it must submit a claim for refund on an individual basis on a special German form which must be filed with the German tax authorities at the following address: Bundesamt fuer Finanzen, Friedhofstrasse 1, 53221 Bonn, Germany. Copies of the required form may be obtained from the German tax authorities at that address or from the Embassy of the Federal Republic of Germany, 4645 Reservoir Road, N.W., Washington, D.C. 20007-1998.

As part of the individual refund claim, a U.S. Holder must submit to the German tax authorities the original bank voucher (or certified copy thereof) issued by the paying entity documenting the tax withheld, and an official certification on IRS Form 6166 of its last filed U.S. federal income tax return. IRS Form 6166 may be obtained by filing a request with the Internal Revenue Service Center in Philadelphia, Pennsylvania, Foreign Certificate Request, P.O. Box 16347, Philadelphia, PA 19114-0447. (Additional information, including IRS Publication 686, can be obtained from the Internal Revenue Service website at [www.irs.gov](http://www.irs.gov)). Requests for certification must be in writing and must include the U.S. Holder's name, Social Security number or employer identification number and tax return form number, and the tax period for which the certification is requested. Requests for certification can include a request to the Internal Revenue Service to send the certification directly to the German tax authorities. If no such request is made, the Internal Revenue Service will send a certificate on IRS Form 6166 to the U.S. Holder, who then must submit the certification with its claim for refund. A certification is valid for three years and need only be resubmitted in a fourth year in the event of a subsequent application for refund.

All claims for refund must be filed within four years of the end of the calendar year in which the dividend was received.

Refunds under the Treaty are not available in respect of shares or ADSs held in connection with a permanent establishment or fixed base in Germany.

***Information Reporting and Backup Withholding***

Dividends on shares or ADSs, and payments of the proceeds of a sale of shares or ADSs, paid within the United States or through certain U.S.-related financial intermediaries are subject to information reporting and may be subject to backup withholding at a 30% rate (for calendar years 2002 and 2003) unless the U.S. Holder (1) is a corporation or other exempt recipient or (2) provides a taxpayer identification number and certifies that no loss of exemption from backup withholding has occurred.

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**DOCUMENTS ON DISPLAY**

We are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended. In accordance with these requirements, we file Annual Reports on Form 20-F and furnish periodic reports on Form 6-K with the Securities and Exchange Commission. These materials, including this Annual Report and the exhibits thereto, may be inspected and copied at the Commission's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549 and at the Commission's regional offices at 500 West Madison Street, Suite 1400, Chicago, Illinois 60661-2511, and 233 Broadway, New York, New York 10274. Copies of the materials may be obtained from the Public Reference Room of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549 at prescribed rates. The public may obtain information on the operation of these Commission's Public Reference Room by calling the Commission in the United States at 1-800-SEC-0330. The Commission also maintains a website at <http://www.sec.gov> that contains reports and proxy information regarding registrants that file electronically with the Commission. In addition, material filed by us can be inspected at the offices of the New York Stock Exchange at 20 Broad Street, New York, New York 10005.

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**ITEM 11. Quantitative and Qualitative Disclosures About Market Risk**

The following discussion should be read in conjunction with Summary of Accounting Principles in the notes to the consolidated financial statements, with note (34) to the consolidated financial statements which provides a summary of the nominal amounts of and terms for derivative financial instruments and note (39) to the consolidated financial statements which provides a summarized comparison of carrying values and fair values of derivative and non-derivative financial instruments and other information relating to those instruments.

**RISK IDENTIFICATION AND ANALYSIS**

We are exposed to market risks primarily from changes in foreign exchange rates, interest rates and share prices associated with assets, liabilities or anticipated transactions that may affect our operating results and financial condition. We seek to minimize market risk through our regular operating and financing activities and, following the evaluation of the exposures, selectively enter into derivative or non-derivative hedging instruments. Hedging instruments are entered into as a rule with major financial institutions with at least a single A credit rating, thereby minimizing the risk of credit loss. We do not enter into derivative financial instruments for trading purposes or other speculative purposes.

The activities of our Central Treasury are subject to policies approved by the Management Board and are monitored by the Supervisory Board. The Central Treasury's policies address the use of derivative financial instruments, including the approval of counterparties, and the investment of excess liquidity. These policies are intended to minimize financial risks and to generate financial advantages for the entire group such as central management of cash resources and needs, cost reduction and the improvement of results from financial transactions. Central Treasury regularly informs the Management Board of the level and value of current market risk exposures. Certain transactions require prior approval by the Management Board. We regard effective market risk management as an important element of our treasury function. Simulations are carried out using market and worst-case scenarios in order to evaluate the effects of different market situations on our financial position. Our Central Treasury, operating as a service center, supplies financial services to individual Deutsche Telekom group entities appropriate to their requirements and local circumstances.

There is no guarantee that this system will consistently identify all of the important risks or provide an adequate assessment of their impact.

The following discussion and tables, which include forward-looking statements that involve risk and uncertainties, summarize our market-sensitive financial instruments and include fair values, maturity and contract terms.

**FOREIGN EXCHANGE RATE RISK**

Currency risks arise from our investing, financing and operating activities. Since our corporate objective is pursued through our commercial operations meaning the sale of telecommunications services unwanted foreign currency exposures are normally hedged, provided the risks would affect our cash flows (transaction risk). Foreign currency risks that do not affect our cash flows (these are risks resulting from the translation of our foreign entities' assets and liabilities into our reporting currency) generally remain unhedged. However, in specific circumstances, we may hedge the foreign currency conversion risk inherent in certain foreign assets, liabilities and results.

For purposes of managing foreign currency risks, a distinction is made in principle between investing, financing and operating activities.

Foreign currency transaction risks in the investment area arise from the acquisition and sale of investments in foreign entities. The Central Treasury hedges these exposures to the extent approved by the Management Board. In August 2002, we changed the hedging instruments related to our investment in shares of redeemable preferred stock of T-Mobile USA. Before the change, we hedged the foreign currency exposure inherent in the shares with short-term foreign currency forward contracts. After the change, the hedging instruments employed

are short-term foreign currency forward contracts, five-year cross-currency interest rate swaps (we pay U.S. dollar at fixed rates and receive euro at fixed rates) and U.S. dollar-denominated long-term debt. At the end of December 2002, there were no hedges for forecasted acquisitions or sales of entities outside the euro zone in the investment area. The translation risk inherent in our net investments in foreign entities was unhedged at December 31, 2002. Effects from currency

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fluctuations on the translation of the net investments are reflected in our consolidated equity position. We were not subject to material foreign currency transaction risk in the investment area at December 31, 2002.

Central Treasury hedges foreign currency risks in the financing area to the maximum extent possible. We use cross-currency interest rate swaps and foreign currency forward contracts in order to effectively convert foreign currency denominated financial liabilities into the group companies' functional currencies (primarily euro, U.S. dollars and British pounds sterling). At December 31, 2002, foreign currency denominated liabilities for which foreign currency is hedged consist primarily of bonds and medium-term notes in Japanese yen, British pounds, Czech koruna and Polish zloty, as well as bank loans in U.S. dollars. A variety of short-term foreign currency inter-company loans are typically hedged with forward contracts. Forward currency contracts to sell Czech koruna and receive euro are used to hedge a euro-denominated bank loan at a foreign subsidiary. As a result of these hedging activities, we believe that we were not subject to material foreign exchange risk in the financing area at December 31, 2002.

In the operating area, individual group entities conduct most of their activities in their respective functional currencies. Therefore, foreign currency transaction risk from our ongoing operations is considered low. Some group entities are, however, exposed to foreign currency transaction risk related to certain anticipated foreign exchange payments. These anticipated foreign exchange payments relate primarily to capital expenditures and expense payments to international telecommunications carriers for completing international calls made by our domestic customers. We occasionally enter into foreign currency forward contracts or foreign currency options to hedge these anticipated payments up to a maximum of one year. These payments are small compared to the group's consolidated cash flows and did not expose the group to material foreign currency transaction risk at December 31, 2002.

The table below provides information about foreign currency derivative instruments. The non-derivative foreign currency denominated assets and liabilities are indicated in the interest rate tables below.

**December 31, 2002****Derivative instruments subject to foreign exchange risk**

	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>Foreign currency forward contracts</b>								
Buy USD/sell EUR <sup>(2)</sup>	687	17	15	11	11	11	752	(25)
Average contractual exchange rate (EUR/USD)	1.01	0.93	0.93	0.93	0.93	0.94	1.00	
Buy GBP/sell EUR <sup>(2)</sup>	1,185						1,185	(28)
Average contractual exchange rate (EUR/GBP)	0.64						0.64	
Buy JPY/sell EUR <sup>(2)</sup>	5						5	0
Average contractual exchange rate (EUR/JPY)	120.07						120.07	
Buy HUF/sell EUR <sup>(2)</sup>	13						13	1
Average contractual exchange rate (EUR/HUF)	253.06						253.06	
Buy USD/sell GBP <sup>(2)</sup>	0						0	0
Average contractual exchange rate (USD/GBP)	1.40						1.40	
Sell USD/buy EUR <sup>(2)</sup>	2,126	35	1	1			2,163	96
Average contractual exchange rate (EUR/USD)	1.00	0.92	0.89	0.90			1.00	
Sell GBP/buy EUR <sup>(2)</sup>	576						576	26
	0.63						0.63	

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Average contractual exchange rate (EUR/GBP)					
Sell JPY/buy EUR <sup>(2)</sup>	8	1	0	9	0
Average contractual exchange rate (EUR/JPY)	119.93	119.59	116.87	119.77	
Sell CHF/buy EUR <sup>(2)</sup>			7	7	0
Average contractual exchange rate (EUR/CHF)			1.44	1.44	
Sell HUF/buy EUR <sup>(2)</sup>	6			6	0
Average contractual exchange rate (EUR/HUF)	249.17			249.17	
Sell CZK/buy EUR <sup>(2)</sup>	156			156	(58)
Average contractual exchange rate (EUR/CZK)	43.39			43.39	
<b>Foreign Currency Options</b>					
Buy USD-Put /EUR-Call <sup>(2)</sup>	4			4	0
Average strike rate (EUR/USD)	0.98			0.98	

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	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>Cross-currency interest rate swaps</b>								
<b>Receive fixed USD, pay fixed EUR(2)</b>						18	18	2
Average pay rate (%) <sup>(1)</sup>						5.17	5.17	
Average receive rate (%) <sup>(1)</sup>						6.56	6.56	
<b>Receive fixed EUR, pay fixed USD(2)</b>					1,604		1,604	80
Average pay rate (%) <sup>(1)</sup>					4.16		4.16	
Average receive rate (%) <sup>(1)</sup>					4.45		4.45	
<b>Receive fixed USD, pay variable EUR(2)</b>						16	16	4
Average pay rate (%) <sup>(1)</sup>						3.56	3.56	
Average receive rate (%) <sup>(1)</sup>						7.05	7.05	
<b>Receive variable USD, pay variable EUR (2)</b>						42	42	(1)
Average pay rate (%) <sup>(1)</sup>						3.57	3.57	
Average receive rate (%) <sup>(1)</sup>						1.84	1.84	
<b>Receive fixed GBP, pay variable EUR(2)</b>	237					396	633	(18)
Average pay rate (%) <sup>(1)</sup>	3.35					5.28	4.56	
Average receive rate (%) <sup>(1)</sup>	5.75					7.13	6.61	
<b>Receive variable EUR, pay variable GBP (2)</b>	37						37	2
Average pay rate (%) <sup>(1)</sup>	4.53						4.53	
Average receive rate (%) <sup>(1)</sup>	3.67						3.67	
<b>Receive fixed JPY, pay variable EUR(2)</b>						246	246	(14)
Average pay rate (%) <sup>(1)</sup>						6.13	6.13	
Average receive rate (%) <sup>(1)</sup>						3.65	3.65	
<b>Receive fixed JPY, pay fixed EUR(2)</b>		326		233		93	652	(121)
Average pay rate (%) <sup>(1)</sup>		5.92		6.36		6.81	6.20	
Average receive rate (%) <sup>(1)</sup>		1.50		1.95		2.40	1.79	
	360		893				1,253	(220)

<b>Receive variable JPY, pay variable EUR (2)</b>			
Average pay rate (%) <sup>(1)</sup>	3.49	2.90	3.07
Average receive rate (%) <sup>(1)</sup>	0.42	(0.06)	0.08
<b>Receive variable JPY, pay fixed EUR(2)</b>			
	831		831 (138)
Average pay rate (%) <sup>(1)</sup>	5.88		5.88
Average receive rate (%) <sup>(1)</sup>	1.17		1.17
<b>Receive fixed EUR, pay variable CHF(2)</b>			
		20	20 0
Average pay rate (%) <sup>(1)</sup>		1.87	1.87
Average receive rate (%) <sup>(1)</sup>		4.31	4.31
<b>Receive variable EUR, pay variable CHF (2)</b>			
	38		38 0
Average pay rate (%) <sup>(1)</sup>	1.33		1.33
Average receive rate (%) <sup>(1)</sup>	3.72		3.72
<b>Receive fixed EUR, pay fixed CZK(2)</b>			
		10	10 0
Average pay rate (%) <sup>(1)</sup>		4.19	4.19
Average receive rate (%) <sup>(1)</sup>		4.31	4.31
<b>Receive variable CZK, pay variable EUR (2)</b>			
		55	55 (3)
Average pay rate (%) <sup>(1)</sup>		3.78	3.78
Average receive rate (%) <sup>(1)</sup>		4.03	4.03
<b>Receive variable CZK, pay variable EUR (2)</b>			
		50	50 (2)
Average pay rate (%) <sup>(1)</sup>		5.10	5.10
Average receive rate (%) <sup>(1)</sup>		4.56	4.56
<b>Receive variable EUR, pay fixed HUF(2)</b>			
		50	50 (9)
Average pay rate (%) <sup>(1)</sup>		9.92	9.92
Average receive rate (%) <sup>(1)</sup>		3.81	3.81
<b>Receive variable EUR, pay variable HUF (2)</b>			
	793		793 (45)
Average pay rate (%) <sup>(1)</sup>	10.18		10.18
Average receive rate (%) <sup>(1)</sup>	3.71		3.71



<b>Receive variable</b>			
<b>EUR, pay variable</b>			
<b>HUF (2)</b>		252	252 (2)
Average pay rate			
(%) <sup>(3)</sup>		BUBOR6M	BUBOR6M
Average receive rate			
(%) <sup>(3)</sup>		EURIBOR6M	EURIBOR6M
<b>Receive variable</b>			
<b>EUR, pay fixed</b>			
<b>SKK(2)</b>	20		20 (9)
Average pay rate			
(%) <sup>(1)</sup>	9.15		9.15
Average receive rate			
(%) <sup>(1)</sup>	3.43		3.43

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	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>Receive fixed PLN, pay variable</b>								
EUR <sup>(2)</sup>					72		72	6
Average pay rate (%) <sup>(1)</sup>					5.66		5.66	
Average receive rate (%) <sup>(1)</sup>					11.57		11.57	

(1) Weighted average settlement rates applicable to the current settlement period.

(2) Represents notional amounts.

(3) Settlement rates applicable to a forward starting period.

The fair value of cross-currency interest rate swaps is affected by changes foreign exchange rates and also by changes in interest rates as described below under Interest Rate Risk.

**INTEREST RATE RISK**

We are exposed to market risk arising from changing interest rates, primarily in the euro-zone, in the United Kingdom and in the United States. In order to mitigate the impact of interest rate fluctuations in these areas we separately manage the interest rate risk for euro, U.S. dollar and British pound-denominated liquid financial assets and liabilities. Once per year, our Management Board specifies a desired mixture of fixed- and floating-rate liquid financial assets and liabilities for a future term of three years. Under consideration of our existing and forecasted debt structure, Central Treasury enters into interest rate derivatives to modify the interest payments on the debt to the mixture defined by our Management Board. As a result of the mentioned derivative hedging activities, 70% of our euro-denominated liquid financial assets and liabilities, 99% of the British pound-denominated liquid financial assets and liabilities, and 83% of the U.S. dollar-denominated liquid financial assets and liabilities, had interest rates that were effectively fixed at December 31, 2002.

The following tables summarize the principal amounts and fair values, maturity and other material contract terms of the interest rate sensitive derivative and non-derivative financial instruments that we held at December 31, 2002.

**December 31, 2002****Assets and related derivative instruments subject to interest rate risk**

	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>ASSETS</b>								
<b>Long-term loans</b>								
Fixed rate, EUR <sup>(3)</sup>	2	2	6	2	2	9	23	23
Average interest rate (%) <sup>(1)</sup>	3.5	3.5	4.8	3.5	3.5	3.5	3.8	
Variable rate, EUR <sup>(3)</sup>	42						42	44
Average interest rate (%) <sup>(1)</sup>	3.2						3.2	
Fixed rate, HRK <sup>(3)</sup>						5	5	5
Average interest rate (%) <sup>(1)</sup>						1.0	1.0	
Fixed rate, HUF <sup>(3)</sup>		9					9	9
Average interest rate (%) <sup>(1)</sup>		10.0					10.0	
Fixed rate, USD <sup>(3)</sup>				11			11	11
Average interest rate (%) <sup>(1)</sup>				7.5			7.5	
Variable rate, USD <sup>(3)</sup>	17						17	17

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Average interest rate (%) <sup>(1)</sup>	6.4			6.4	
<b>Investments in non-current securities</b>					
Fixed rate, EUR <sup>(3)</sup>	101	2	1	104	104
Average interest rate (%) <sup>(1)</sup>	4.5	3.4	4.5	4.5	
Variable rate, EUR <sup>(3)</sup>				2	2
Average interest rate (%) <sup>(1)</sup>					2
Fixed rate, GBP <sup>(3)</sup>	72			72	72
Average interest rate (%) <sup>(1)</sup>	5.0			5.0	
Fixed rate, HRK <sup>(3)</sup>	5	27	14	7	53
Average interest rate (%) <sup>(1)</sup>	8.0	8.5	8.4	6.9	8.2
Fixed rate, SKK <sup>(3)</sup>	2			2	2
Average interest rate (%) <sup>(1)</sup>	11.5			11.5	
Fixed rate, USD <sup>(3)</sup>	5			5	5
Average interest rate (%) <sup>(1)</sup>	9.5			9.5	

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	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>Investments in marketable securities</b>								
Fixed rate EUR <sup>(3)</sup>	27	343					370	370
Average interest rate (%) <sup>(1)</sup>	6.3	5.1					5.2	
Variable rate HRK <sup>(3)</sup>	34						34	34
Average interest rate (%) <sup>(1)</sup>	5.3						5.3	
Fixed rate HUF <sup>(3)</sup>	2						2	2
Average interest rate (%) <sup>(1)</sup>	9.5						9.5	
<b>Liquid Assets</b>								
Fixed rate EUR <sup>(3)</sup>	343						343	343
Average interest rate (%) <sup>(1)</sup>	3.4						3.4	
Variable rate, EUR <sup>(3)</sup>	364						364	364
Average interest rate (%) <sup>(1)</sup>	2.9						2.9	
Variable rate BRL <sup>(3)</sup>	9						9	9
Average interest rate (%) <sup>(1)</sup>	24.9						24.9	
Variable rate CHF <sup>(3)</sup>	125						125	125
Average interest rate (%) <sup>(1)</sup>	0.6						0.6	
Variable rate, CZK <sup>(3)</sup>	44						44	44
Average interest rate (%) <sup>(1)</sup>	2.5						2.5	
Variable rate, GBP <sup>(3)</sup>	195						195	195
Average interest rate (%) <sup>(1)</sup>	4.0						4.0	
Variable rate, HRK <sup>(3)</sup>	385						385	385
Average interest rate (%) <sup>(1)</sup>	3.9						3.9	
Variable rate, HUF <sup>(3)</sup>	41						41	41
Average interest rate (%) <sup>(1)</sup>	8.4						8.4	
Variable rate, JPY <sup>(3)</sup>	(2)						(2)	(2)
Average interest rate (%) <sup>(1)</sup>	0.1						0.1	
Variable rate, PLN <sup>(3)</sup>	2						2	2
Average interest rate (%) <sup>(1)</sup>	6.7						6.7	
Variable rate, SGD <sup>(3)</sup>	8						8	8
Average interest rate (%) <sup>(1)</sup>	0.8						0.8	
Variable rate, SKK <sup>(3)</sup>	307						307	307
Average interest rate (%) <sup>(1)</sup>	5.1						5.1	
Fixed rate USD <sup>(3)</sup>	1						1	1
Average interest rate (%) <sup>(1)</sup>	0.8						0.8	
Variable rate, USD <sup>(3)</sup>	74						74	74
Average interest rate (%) <sup>(1)</sup>	1.4						1.4	
Variable rate, ZAR <sup>(3)</sup>	9						9	9
Average interest rate (%) <sup>(1)</sup>	13.5						13.5	

(1) Weighted average settlement rates applicable to the current settlement period.

(2) Represents notional amounts.

(3) Maturity amounts presented in book value.

**December 31, 2002****Liabilities and related derivative instruments subject to interest rate risk**

	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>LIABILITIES</b>								

**Bonds and  
debentures, EUR**

Fixed rate <sup>(4)</sup>	5,754	9,830	3,246	4,560	3,500	9,540	36,430	37,933
Average interest rate (%) <sup>(1)</sup>	4.9	7.2	5.7	5.8	7.0	6.7	6.4	
Variable rate <sup>(4)</sup>	1,916	1,050	350	128			3,444	3,469
Average interest rate (%) <sup>(1)</sup>	3.6	3.9	5.0	4.4			3.9	

**Bonds and  
debentures, GBP**

Fixed rate <sup>(4)</sup>	231		960			1,620	2,811	2,871
Average interest rate (%) <sup>(1)</sup>	5.8		7.1			7.2	7.1	

**Bonds and  
debentures, USD**

Fixed rate <sup>(4)</sup>	182	124	3,059			7,720	11,085	12,813
Average interest rate (%) <sup>(1)</sup>	1.8	6.2	7.6			8.5	8.1	

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	Maturities						Total	Fair Value
	2003	2004	2005	2006	2007	Thereafter		
(millions of euro)								
<b>Bonds and debentures, CZK</b>								
Fixed rate <sup>(4)</sup>		159					159	173
Average interest rate (%) <sup>(1)</sup>		8.2					8.2	
Variable rate <sup>(1)</sup>			50				50	52
Average interest rate (%) <sup>(1)</sup>			4.3				4.3	
<b>Bonds and debentures, JPY</b>								
Fixed rate <sup>(4)</sup>	5	326	727	233		93	1,384	1,405
Average interest rate (%) <sup>(1)</sup>	0.4	1.5	1.5	2.0		2.4	1.6	
Variable rate <sup>(4)</sup>	350	831					1,181	1,205
Average interest rate (%) <sup>(1)</sup>	0.4	1.7					1.3	
<b>Bonds and debentures, HUF</b>								
Fixed rate <sup>(4)</sup>	55					1	56	56
Average interest rate (%) <sup>(1)</sup>	9.2					0.0	9.1	
Variable rate <sup>(4)</sup>	42						42	43
Average interest rate (%) <sup>(1)</sup>	10.3						10.3	
<b>Bonds and debentures, PLN</b>								
Fixed rate <sup>(4)</sup>					110		110	124
Average interest rate (%) <sup>(1)</sup>					9.7		9.7	
<b>Liabilities to banks, EUR</b>								
Fixed rate <sup>(4)</sup>	804	335	157	21	102	571	1,990	2,037
Average interest rate (%) <sup>(1)</sup>	6.1	6.7	6.5	5.8	6.9	7.1	6.6	
Variable rate <sup>(4)</sup>	133	1	2			270	406	411
Average interest rate (%) <sup>(1)</sup>	3.3	4.7	3.9			3.2	3.2	
<b>Liabilities to banks, AUD</b>								
Variable rate <sup>(4)</sup>	3						3	3
Average interest rate (%) <sup>(1)</sup>	8.8						8.8	
<b>Liabilities to banks, GBP</b>								
Fixed rate <sup>(4)</sup>	108	69	2,329	110	111	519	3,246	3,258
Average interest rate (%) <sup>(1)</sup>	4.6	6.3	4.8	6.3	6.3	6.7	5.2	
Variable rate <sup>(4)</sup>	36	38	38	19			131	131
Average interest rate (%) <sup>(1)</sup>	4.2	4.2	4.2	4.2			4.2	
<b>Liabilities to banks, USD</b>								

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Fixed rate <sup>(4)</sup>	4	4	4	4	4	14	34	36
Average interest rate (%) <sup>(1)</sup>	6.8	6.8	6.8	6.8	6.8	6.8	6.8	
Variable rate <sup>(4)</sup>	2	3	3	3	3	20	34	34
Average interest rate (%) <sup>(1)</sup>	1.5	1.6	1.6	1.6	1.6	1.6	1.6	
<b>Liabilities to banks, HUF</b>								
Fixed rate <sup>(4)</sup>	128	56	1	1	1		187	197
Average interest rate (%) <sup>(1)</sup>	8.8	11.5	0.0	0.0	0.0		9.4	
Variable rate <sup>(4)</sup>	122	39	48	3	13	23	248	248
Average interest rate (%) <sup>(1)</sup>	8.6	8.6	8.7	9.1	8.8	9.3	8.7	
<b>Liabilities to banks, JPY</b>								
Fixed rate <sup>(4)</sup>	1						1	1
Average interest rate (%) <sup>(1)</sup>	0.7						0.7	
<b>Liabilities to banks, CZK</b>								
Fixed rate <sup>(4)</sup>		1					1	1
Average interest rate (%) <sup>(1)</sup>		9.5					9.5	
Variable rate <sup>(4)</sup>		11					11	11
Average interest rate (%) <sup>(1)</sup>		3.1					3.1	
<b>EUR interest rate swaps</b>								
Receive variable, pay fixed <sup>(2)</sup>	2,097		892		307	1,356	4,652	(336)
Average pay rate (%) <sup>(1)</sup>	4.54		5.65		5.82	5.90	5.23	
Average receive rate (%) <sup>(1)</sup>	3.23		2.90		3.01	2.94	3.07	
<b>EUR interest rate swaps</b>								
Receive fixed pay variable <sup>(2)</sup>	3,175	7,156			332	1,356	12,019	364
Average pay rate (%) <sup>(1)</sup>	3.31	3.29			3.22	2.94	3.26	
Average receive rate (%) <sup>(1)</sup>	4.57	4.21			5.12	5.22	4.44	
<b>Forward EUR interest rate swaps</b>								
Receive fixed pay variable <sup>(2)</sup>			820				820	22
Average pay rate (%) <sup>(3)</sup>			EURIBOR6M				EURIBOR6M	
Average receive rate (%) <sup>(3)</sup>			4.21				4.21	

**Table of Contents****Maturities**

	2003	2004	2005	2006	2007	Thereafter	Total	Fair Value
(millions of euro)								
<b>GBP interest rate swaps</b>								
Receive variable, pay fixed <sup>(2)</sup>	115		1,075	385			1,575	(71)
Average pay rate (%) <sup>(1)</sup>	6.64		5.97	5.53			5.91	
Average receive rate (%) <sup>(1)</sup>	3.94		3.93	3.94			3.94	
<b>Forward GBP interest rate swaps</b>								
Receive variable, pay fixed <sup>(2)</sup>			307				307	(12)
Average pay rate (%) <sup>(1)</sup>			6.04				6.04	
Average receive rate (%) <sup>(1)</sup>		GBP (LIBOR6M)				GBP (LIBOR6M)		
<b>JPY interest rate swaps</b>								
Receive fixed, pay variable <sup>(2)</sup>			723				723	20
Average pay rate (%) <sup>(1)</sup>			0.32				0.32	
Average receive rate (%) <sup>(1)</sup>			1.50				1.50	
<b>USD interest rate swaps</b>								
Receive fixed, pay variable <sup>(2)</sup>						1,144	1,144	265
Average pay rate (%) <sup>(1)</sup>						2.11	2.11	
Average receive rate (%) <sup>(1)</sup>						8.00	8.00	
<b>Forward USD interest rate swaps</b>								
Receive variable, pay fixed <sup>(2)</sup>					2,859		2,859	(175)
Average pay rate (%) <sup>(3)</sup>					5.07		5.07	
Average receive rate (%) <sup>(3)</sup>						USD (LIBOR6M)	USD (LIBOR6M)	
<b>Forward HUF interest</b>								



<b>rate swaps</b>			
Receive			
variable, pay			
fix <sup>(2)</sup>	269	269	(11)
Average pay			
rate (%) <sup>(3)</sup>	9.25	9.25	
Average			
receive rate			
(%) <sup>(3)</sup>	BUBOR6M	BUBOR6M	
<b>CZK interest</b>			
<b>rate swaps</b>			
Receive			
fixed, pay			
variable <sup>(2)</sup>	13	13	1
Average pay			
rate (%) <sup>(1)</sup>	3.18	3.18	
Average			
receive rate			
(%) <sup>(1)</sup>	8.14	8.14	
<b>GBP interest</b>			
<b>rate caps</b>			
<b>purchased<sup>(2)</sup></b>	38	38	0
Average cap			
strike rate	7.5	7.5	

(1) Weighted average settlement rates applicable to the current settlement period.

(2) Represents notional amounts.

(3) Settlement rates applicable to a forward starting period.

(4) Maturity amounts presented in book value.

#### EQUITY PRICE RISK

We continuously evaluate investment opportunities in order to meet our business and strategic goals. With limited exceptions, it is our intention not to hedge fair value changes of our equity investments arising from fluctuations in quoted share prices. The table below presents the cost and fair value of those marketable equity securities comprising investments in start-up companies as well as other participations we held at December 31, 2002 which are sensitive to changes in share prices.

	December 31, 2002	
	Assets subject to equity price risk	
	Carrying value	Fair Value
	(millions of euro)	
Investments in marketable equity securities	752	907

#### CHANGES IN MARKET RISK EXPOSURE IN 2002 COMPARED TO 2001

The issuance of medium-term notes denominated in British pounds, Japanese yen, Polish zloty and Czech koruna and borrower's note loans in Japanese yen in 2002 did not lead to any material increase in foreign currency transaction exposure, as these debt instruments were converted into euro using cross-currency interest rate swaps.

In accordance with the transfer of an intercompany British pound-denominated loan asset into an equity interest at the end of 2001, cross-currency swaps (we paid British pounds at variable rates and received U.S. dollars at variable rates) and British pound interest rate swaps (we paid British pounds at fixed rates and



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received British pounds at variable rates) used to hedge the foreign currency and interest rate risks inherent in the intercompany loan asset were terminated early at the beginning of 2002.

To achieve the defined mixture of fixed and floating rate debt in our functional currencies, Central Treasury entered into forward U.S. dollar-denominated interest rate swaps (we will pay U.S. dollars at fixed rates and will receive U.S. dollars at variable rates) and cross-currency interest rate swaps (we pay U.S. dollars at fixed rates and receive euro at fixed rates) in 2002. In addition, we early terminated U.S. dollar-denominated interest rate swaps (we paid U.S. dollars at variable rates and received U.S. dollars at fixed rates), euro-denominated interest rate swaps (we paid euro at fixed rates and received euro at variable rates) and cross-currency interest rate swaps (we paid euro at variable rates and received U.S. dollars at variable rates). The result of these adjustments is that the level of U.S. dollar liquid financial assets and liabilities at fixed rates increased whereas the level of euro liquid financial assets and liabilities at fixed rates declined. The termination of cross-currency swaps reduced the euro-denominated debt and increased the U.S. dollar-denominated debt position. Further, we terminated British pound-denominated interest swaps (we paid British pounds at fixed rates and received British pounds at variable rates) in 2002 to reduce the level of British pound-denominated liquid financial assets and liabilities at fixed rates. At December 31, 2002 interest rates for 70% of the euro liquid financial assets and liabilities and 99% of the British pound liquid financial assets and liabilities were effectively fixed compared to 75% and 85% at December 31, 2001. The effective U.S. dollar fixed rate debt level, which was 83% at December 31, 2002, was measured and managed for the first time in 2002.

**ITEM 12. Description of Securities Other than Equity Securities**

Not applicable.

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**PART II**

**ITEM 13. Defaults, Dividend Arrearages and Delinquencies**

Not applicable.

**ITEM 14. Material Modifications to the Rights of Security Holders and Use of Proceeds**

Not applicable.

**ITEM 15. Controls and Procedures**

Within 90 days prior to the date of this report (the Evaluation Date), our Chairman of the Management Board and Deputy Chairman of the Management Board carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13(a)-14(c) and 15(d)-14(c) of the Securities Exchange Act of 1934, as amended). Based on that evaluation, these officers have concluded that as of the Evaluation Date, our disclosure controls and procedures were effective and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within these entities.

There were no significant changes in our internal controls, or in other factors that could significantly affect these controls subsequent to the Evaluation Date, and no corrective actions with regard to significant deficiencies and material weaknesses were undertaken.

**ITEM 16. [Reserved]**

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**PART III**

**ITEM 17. Financial Statements**

Not applicable.

**ITEM 18. Financial Statements**

See pages F-1 through F-90.

Separate financial statements required by Rule 3-09 of Regulation S-X are included on pages A-1 through A-208 in this Annual Report.

**ITEM 19. Exhibits**

Documents filed as exhibits to this Annual Report.

- 1.1 Memorandum and Articles of Association (*Satzung*) of Deutsche Telekom AG as amended to date (English translation included).
- 2.1 Indenture dated as of July 6, 2000, relating to debt securities of Deutsche Telekom International Finance B.V. (incorporated by reference to Deutsche Telekom's Registration Statement on Form F-3, File No. 333-12096).
- 2.2 Except as noted above, the total amount of long-term debt securities of Deutsche Telekom AG authorized under any instrument does not exceed 10% of the total assets of the group on a consolidated basis. Deutsche Telekom AG hereby agrees to furnish to the Commission, upon its request, a copy of any instrument defining the rights of holders of long-term debt of Deutsche Telekom AG or of its subsidiaries for which consolidated or unconsolidated financial statements are required to be filed.
- 4.1 Agreement and Plan of Merger dated as of July 23, 2000, as amended and restated on February 8, 2001, and as amended on April 13, 2001, between Deutsche Telekom AG and VoiceStream Wireless Corporation and Bega, Inc. (incorporated by reference to Deutsche Telekom's registration statement on Form F-4, File No. 333-47306, as amended through February 9, 2001).
- 4.2 Amendment No. 1 dated as of April 13, 2001, to the Merger Agreement among Deutsche Telekom AG, VoiceStream and a Delaware corporation formed by Deutsche Telekom AG (incorporated herein by reference to Exhibit 29 to Deutsche Telekom AG's Amendment No. 4 to Schedule 13D in respect to VoiceStream filed on May 1, 2001).
- 8.1 List of subsidiaries as of the end of the year covered by this Annual Report.\*
- 10.1 Consent of Ernst & Young Deutsche Allgemeine Treuhand AG Wirtschaftspruefungsgesellschaft and PwC Deutsche Revision Aktiengesellschaft Wirtschaftspruefungsgesellschaft.
- 10.2 Consent of PwC Deutsche Revision Aktiengesellschaft Wirtschaftspruefungsgesellschaft.
- 10.3 Consent of PricewaterhouseCoopers Accountants N.V.
- 10.4 Consent of PwC Deutsche Revision Aktiengesellschaft Wirtschaftspruefungsgesellschaft.
- 10.5 Consent of ZAO Deloitte & Touche CIS.

10.6 Statement Regarding Consent of Arthur Andersen and Arthur Andersen Sp. z o.o.

99.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002.

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\* Previously filed and incorporated by reference herein.

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and has duly caused and authorized the undersigned to sign this Annual Report or amendment thereto on its behalf.

DEUTSCHE TELEKOM AG

By: /s/ KAI-UWE RICKE

Name: Kai-Uwe Ricke  
Title: Chairman of the Management Board

By: /s/ KARL-GERHARD EICK

Name: Karl-Gerhard Eick  
Title: Deputy Chairman of the Management Board  
Finance and Controlling

Date: June 27, 2003

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**Certification Pursuant to Section 302 of The Sarbanes-Oxley Act of 2002**

I, Kai-Uwe Ricke, certify that:

1. I have reviewed this annual report on Form 20-F of Deutsche Telekom;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and
  - c. presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective action with regard to significant deficiencies and material weaknesses.

/s/ KAI-UWE RICKE

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Kai-Uwe Ricke  
Chairman of the Management Board

Date: June 27, 2003

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**Certification Pursuant to Section 302 of The Sarbanes-Oxley Act of 2002**

I, Karl-Gerhard Eick, certify that:

1. I have reviewed this annual report on Form 20-F of Deutsche Telekom;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and
  - c. presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective action with regard to significant deficiencies and material weaknesses.

/s/ KARL-GERHARD EICK

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Karl-Gerhard Eick  
Deputy Chairman of the Management Board  
Finance and Controlling

Date: June 27, 2003

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Consolidated Financial Statements of Mobile TeleSystems as of and for the years ended December 31, 2002, 2001 and 2000	A-23
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**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Board of Management and Shareholders of Deutsche Telekom AG

We have audited the accompanying consolidated balance sheets of Deutsche Telekom AG as of December 31, 2002 and 2001, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Deutsche Telekom AG at December 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in Germany.

Accounting principles generally accepted in Germany vary in certain important respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected the determination of consolidated results of operations for the years ended December 31, 2002 and 2001, and the determination of consolidated shareholders' equity and consolidated financial position at December 31, 2002 and 2001 to the extent summarized in Notes 40, 41, 42 and 43 to the consolidated financial statements.

March 17, 2003

Ernst & Young

Deutsche Allgemeine Treuhand AG  
Wirtschaftspruefungsgesellschaft  
Stuttgart

(Prof. Dr. Pfitzer)  
Wirtschaftspruefer

(Hollweg)  
Wirtschaftspruefer

PwC Deutsche Revision

Aktiengesellschaft  
Wirtschaftspruefungsgesellschaft  
Frankfurt am Main

(Frings)  
Wirtschaftspruefer

(Laue)  
Wirtschaftspruefer

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**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Board of Management and Shareholders of Deutsche Telekom AG

We have audited the accompanying consolidated statements of operations, shareholders' equity, and cash flows for the year ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects the consolidated results of operations and cash flows of Deutsche Telekom AG for the year ended December 31, 2000 in conformity with accounting principles generally accepted in Germany.

Accounting principles generally accepted in Germany vary in certain important respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected the determination of consolidated net income for the year ended December 31, 2000 to the extent summarized in Notes 40, 41, 42 and 43 to the consolidated financial statements.

Frankfurt am Main  
March 26, 2001,  
except for Notes 40, 41, 42 and 43 as to which the date is February 13, 2002

PwC Deutsche Revision

Aktiengesellschaft  
Wirtschaftspruefungsgesellschaft

(Frings)  
Wirtschaftspruefer

(Laue)  
Wirtschaftspruefer

**Table of Contents****CONSOLIDATED STATEMENTS OF OPERATIONS**

	Notes	For the year ended December 31,		
		2002	2001	2000
		(millions of )		
<b>Net revenue</b>	(1)	<b>53,689</b>	<b>48,309</b>	<b>40,939</b>
Change in inventories and other own capitalized costs	(2)	534	879	864
<b>Total operating performance</b>		<b>54,223</b>	<b>49,188</b>	<b>41,803</b>
Other operating income	(3)	3,901	6,619	11,002
Goods and services purchased	(4)	(14,418)	(13,477)	(11,950)
Personnel costs	(5)	(13,480)	(12,114)	(9,718)
Depreciation and amortization	(6)	(36,880)	(15,221)	(12,991)
Other operating expenses	(7)	(14,110)	(12,151)	(10,424)
Financial income (expense), net	(8)	(6,022)	(5,348)	(1,230)
<b>Results from ordinary business activities</b>		<b>(26,786)</b>	<b>(2,504)</b>	<b>6,492</b>
Extraordinary losses	(9)			(159)
Income tax expense (benefit)	(10)	2,483	(808)	(318)
<b>Income (loss) after taxes</b>		<b>(24,303)</b>	<b>(3,312)</b>	<b>6,015</b>
Losses applicable to minority shareholders	(11)	(284)	(142)	(89)
<b>Net income (loss)</b>		<b>(24,587)</b>	<b>(3,454)</b>	<b>5,926</b>
<b>Earnings (loss) per share in</b>		<b>(5.86)</b>	<b>(0.93)</b>	<b>1.96</b>

The accompanying notes are an integral part of the consolidated financial statements.

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## CONSOLIDATED BALANCE SHEETS

	Notes	As of December 31,	
		2002	2001
(millions of \$)			
<b>Assets</b>			
<b>Noncurrent assets</b>			
Intangible assets	(12)	53,402	80,051
Property, plant and equipment	(13)	53,955	58,708
Financial assets	(14)	4,169	7,957
		<b>111,526</b>	<b>146,716</b>
<b>Current assets</b>			
Inventories, materials and supplies	(15)	1,556	1,671
Receivables	(16)	6,258	6,826
Other assets	(17)	3,392	4,966
Marketable securities	(18)	413	702
Liquid assets	(19)	1,905	2,868
		<b>13,524</b>	<b>17,033</b>
<b>Prepaid expenses, deferred charges and deferred taxation</b>	(20)	<b>771</b>	<b>813</b>
		<b>125,821</b>	<b>164,562</b>
<b>Shareholders' equity and liabilities</b>			
<b>Shareholders' equity</b>			
Capital stock	(21)	10,746	10,746
Additional paid-in capital	(22)	50,077	49,994
Retained earnings	(23)	248	5,179
Unappropriated net income carried forward from previous year		23	101
Net loss		(24,587)	(3,454)
Cumulative translation adjustment account		(5,079)	(1,572)
Minority interest	(24)	3,988	5,307
		<b>35,416</b>	<b>66,301</b>
<b>Accruals</b>			
Pensions and similar obligations	(25)	3,942	3,661
Other accruals	(26)	12,155	14,766
		<b>16,097</b>	<b>18,427</b>
<b>Liabilities</b>			
Debt	(27)	63,044	67,031
Other		10,541	12,020
		<b>73,585</b>	<b>79,051</b>

<b>Deferred income</b>	<u>723</u>	<u>783</u>
	<b>125,821</b>	<b>164,562</b>

The accompanying notes are an integral part of the consolidated financial statements.

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**Table of Contents****CONSOLIDATED NONCURRENT ASSETS****Acquisition or production cost**

(millions of )	Jan. 1, 2002	Translation adjustment	Changes in the composition of the Deutsche Telekom Group	Acquisition or production cost		Reclassi- fications	Dec. 31, 2002
				Additions	Disposals		
<b>Intangible assets</b>							
Concessions, industrial and similar rights and assets, and licences in such rights and assets	43,168	(4,318)	1,008	776	756	896	40,774
Goodwill statements	46,075	(4,509)	215	4,482	23	635	46,875
Advance payments	200	1	1	97	5	(160)	134
	<b>89,443</b>	<b>(8,826)</b>	<b>1,224</b>	<b>5,355</b>	<b>784</b>	<b>1,371</b>	<b>87,783</b>
<b>Property, plant and equipment</b>							
Land and equivalent rights, and buildings including buildings on land owned by third parties	19,901	(19)	191	177	1,569	98	18,779
Technical equipment and machinery	81,905	(830)	412	3,435	1,413	2,951	86,460
Other equipment, plant and office equipment	6,955	(116)	3	816	437	(648)	6,573
Advance payments and construction in progress	2,955	(149)	23	2,627	20	(3,162)	2,274
	<b>111,716</b>	<b>(1,114)</b>	<b>629</b>	<b>7,055</b>	<b>3,439</b>	<b>(761)</b>	<b>114,086</b>
<b>Financial assets</b>							
Investments in unconsolidated subsidiaries	297	0	27	29	39	(4)	310
Loans to unconsolidated subsidiaries	82	0	0	22	46	0	58
	4,776	(425)	(193)	551	566	(992)	3,151



Investments in associated companies							
Other investments in related companies	2,303	(8)	1	46	1,236	382	1,488
Long-term loans to associated and related companies	870	(4)	(25)	5	29	(17)	800
Other investments in noncurrent securities	903	(1)	0	50	319	(11)	622
Other long-term loans	535	(2)	(236)	49	257	32	121
	<u>9,766</u>	<u>(440)</u>	<u>(426)</u>	<u>752</u>	<u>2,492</u>	<u>(610)</u>	<u>6,550</u>
	<u>210,925</u>	<u>(10,380)</u>	<u>1,427</u>	<u>13,162</u>	<u>6,715</u>	<u>0</u>	<u>208,419</u>

[Additional columns below]

[Continued from above table, first column(s) repeated]

## Depreciation, amortization and write-downs

(millions of \$)	Jan. 1, 2002	Translation adjustment	Changes in the composition of the Deutsche Telekom Group	Additions
<b>Intangible assets</b>				
Concessions, industrial and similar rights and assets, and licences in such rights and assets	3,914	(1,321)	512	14,242
Goodwill statements	5,478	(1,295)	74	13,108
Advance payments	0	0	0	5
	<u>9,392</u>	<u>(2,616)</u>	<u>586</u>	<u>27,355</u>
<b>Property, plant and equipment</b>				
Land and equivalent rights, and buildings including buildings on land owned by third parties	6,838	(7)	38	928
Technical equipment and machinery	41,958	(172)	94	7,607

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Other equipment, plant and office equipment	4,212	(46)	(14)	989
Advance payments and construction in progress	0	0	0	1
	<u>53,008</u>	<u>(225)</u>	<u>118</u>	<u>9,525</u>
<b>Financial assets</b>				
Investments in unconsolidated subsidiaries	69	0	28	102
Loans to unconsolidated subsidiaries	0	0	0	0
Investments in associated companies	832	(29)	1	316
Other investments in related companies	408	(1)	0	678
Long-term loans to associated and related companies	475	0	1	322
Other investments in noncurrent securities	24	0	0	384
Other long-term loans	1	0	0	13
	<u>1,809</u>	<u>(30)</u>	<u>30</u>	<u>1,815</u>
	<u>64,209</u>	<u>(2,871)</u>	<u>734</u>	<u>38,695</u>

[Additional columns below]

[Continued from above table, first column(s) repeated]

(millions of )	Depreciation, amortization and write-downs				Net carrying amount	
	Disposals	Reclassifications	Reinstated depreciation	Dec. 31, 2002	Dec. 31, 2002	Dec. 31, 2001
<b>Intangible assets</b>						
Concessions, industrial and similar rights and assets, and licences in such rights and assets	732	329	7	16,937	23,837	39,254
Goodwill	23	97	0	17,439	29,436	40,597
Advance payments	0	0	0	5	129	200

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	755	426	7	34,381	53,402	80,051
<b>Property, plant and equipment</b>						
Land and equivalent rights, and buildings including buildings on land owned by third parties	434	55	1	7,417	11,362	13,063
Technical equipment and machinery	1,171	110	0	48,426	38,034	39,947
Other equipment, plant and office equipment	366	(485)	3	4,287	2,286	2,743
Advance payments and construction in progress	0	0	0	1	2,273	2,955
	1,971	(320)	4	60,131	53,955	58,708
<b>Financial assets</b>						
Investments in unconsolidated subsidiaries	32	0	6	161	149	228
Loans to unconsolidated subsidiaries	0	0	0	0	58	82
Investments in associated companies	137	(425)	0	558	2,593	3,944
Other investments in related companies	937	319	0	467	1,021	1,895
Long-term loans to associated and related companies	1	0	0	797	3	395
Other investments in noncurrent securities	24	0	0	384	238	879
Other long-term loans	0	0	0	14	107	534
	1,131	(106)	6	2,381	4,169	7,957
	3,857	0	17	96,893	111,526	146,716

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the year ended December 31,		
	2002	2001	2000
	(millions of \$)		
Net income (loss)	(24,587)	(3,454)	5,926
Income applicable to minority shareholders	284	142	89
<b>Income (loss) after taxes</b>	<b>(24,303)</b>	<b>(3,312)</b>	<b>6,015</b>
Depreciation and amortization	36,880	15,221	12,991
Income tax (expense) benefit	(2,847)	751	194
Net interest expense	4,048	4,138	3,097
Net gains from the disposition of noncurrent assets	(428)	(1,106)	(4,796)
Results from associated companies	430	547	(1,890)
Other noncash transactions	1,144	(1,146)	(2,661)
(Increase) decrease in capitalized working capital*	184	428	(1,791)
(Increase) decrease in accruals	1,410	(136)	1,078
Decrease in other working capital carried as a liability**	101	761	1,391
Income taxes (paid) received	(15)	10	(871)
Dividends received	63	115	189
<b>Cash generated from operations</b>	<b>16,667</b>	<b>16,271</b>	<b>12,946</b>
Interest paid	(6,112)	(4,779)	(3,873)
Interest received	1,908	442	927
<b>Net cash provided by operating activities</b>	<b>12,463</b>	<b>11,934</b>	<b>10,000</b>
Cash outflows from investments in			
intangible assets	(841)	(1,021)	(15,980)
property, plant and equipment	(6,784)	(9,847)	(7,556)
financial assets	(568)	(498)	(8,487)
consolidated companies	(6,405)	(5,695)	(4,343)
Cash inflows from disposition of			
intangible assets	14	208	10
property, plant and equipment	1,304	1,146	655
financial assets	1,130	3,514	4,474
shareholdings in consolidated companies and business units	697	1,004	3,114
Net change in short-term investments and marketable securities	226	4,440	401
Other	1,187	1,384	6
<b>Net cash used for investing activities</b>	<b>(10,040)</b>	<b>(5,365)</b>	<b>(27,706)</b>
Net repayment of short-term debt	(10,012)	(10,266)	(780)
Issuance of medium and long-term debt	11,677	13,949	19,708
Repayments of medium and long-term debt	(3,472)	(6,589)	(2,408)
Dividends paid	(1,582)	(1,905)	(1,914)
Proceeds from share offering	1		3,255
Change in minority interests	(47)		2
	<b>(3,435)</b>	<b>(4,811)</b>	<b>17,863</b>

**Net cash provided by (used for) financing activities**

Effect of foreign currency exchange rate changes on cash and cash equivalents	(14)	(26)	(29)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(1,026)</b>	<b>1,732</b>	<b>128</b>
<b>Cash and cash equivalents, at beginning of year</b>	<b>2,738</b>	<b>1,006</b>	<b>878</b>
<b>Cash and cash equivalents, at end of year</b>	<b>1,712</b>	<b>2,738</b>	<b>1,006</b>

\* Change in receivables, liabilities, other assets, inventories, materials and supplies and prepaid expenses and deferred charges.

\*\* Change in other liabilities (which do not relate to financing activities) and deferred income.

The accompanying notes are an integral part of the consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

millions of	Capital stock nominal value	Additional paid-in capital	Consolidated shareholders equity generated			Cumulative translation adjustment account	Shareholders equity in acc. with consol. bal. sheet
			Retained earnings	Unappr. net income (loss) carried forward	Net income (loss)		
<b>Balance at Jan. 1, 2000</b>	<b>7,756</b>	<b>24,121</b>	<b>1,842</b>	<b>13</b>	<b>1,253</b>	<b>(284)</b>	<b>34,701</b>
Changes in the composition of the Group			(31)				(31)
Dividends for 1999			(621)		(1,253)		(1,874)
Unappropriated net income carried forward from previous year			(31)	31			
Increase in nominal value of capital stock		169					169
Reduction of treasury stock							
Income after taxes					5,926		5,926
Difference from currency translation						(477)	(477)
<b>Balance at Dec. 31, 2000</b>	<b>7,756</b>	<b>24,290</b>	<b>1,159</b>	<b>44</b>	<b>5,926</b>	<b>(761)</b>	<b>38,414</b>
Changes in the composition of the Group							
Dividends for 2000				(1,877)			(1,877)
Unappropriated net income carried forward			3,992	1,934	(5,926)		
Stock issued for the acquisition of VoiceStream/Powertel	2,990	25,704					28,694
Loss after taxes					(3,454)		(3,454)
Difference from currency translation			28			(811)	(783)
<b>Balance at Dec. 31, 2001</b>	<b>10,746</b>	<b>49,994</b>	<b>5,179</b>	<b>101</b>	<b>(3,454)</b>	<b>(1,572)</b>	<b>60,994</b>
Changes in the composition of the Group							
Dividends for 2001				(1,539)			(1,539)
Unappropriated net income carried forward			(4,915)	1,461	3,454		
Stock issued on exercise of stock options, warrants and exchange rights		83					83
Loss after taxes					(24,587)		(24,587)
Difference from currency translation			(16)			(3,507)	(3,523)

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<b>Balance at Dec. 31, 2002</b>	<b>10,746</b>	<b>50,077</b>	<b>248</b>	<b>23</b>	<b>(24,587)</b>	<b>(5,079)</b>	<b>31,428</b>
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[Additional columns below]

[Continued from above table, first column(s) repeated]

millions of	Treasury shares(1)	Total	Minority interest		Total in acc. with cons. bal. Sheet	Consol. shareholders equity(1)
			Minority interest capital	Cumulative translation adjustment account		
<b>Balance at Jan. 1, 2000</b>	<b>(14)</b>	<b>34,687</b>	<b>1,545</b>	<b>(557)</b>	<b>988</b>	<b>35,675</b>
Changes in the composition of the Group		(31)	3,058		3,058	3,027
Dividends for 1999		(1,874)	(25)		(25)	(1,899)
Unappropriated net income carried forward from previous year						
Increase in nominal value of capital stock		169				169
Reduction of treasury stock	7	7				7
Income after taxes		5,926	89		89	6,015
Difference from currency translation		(477)		192	192	(285)
<b>Balance at Dec. 31, 2000</b>	<b>(7)</b>	<b>38,407</b>	<b>4,667</b>	<b>(365)</b>	<b>4,302</b>	<b>42,709</b>
Changes in the composition of the Group			808		808	808
Dividends for 2000		(1,877)	(33)		(33)	(1,910)
Unappropriated net income carried forward						
Stock issued for the acquisition of VoiceStream/Powertel		28,694				28,694
Loss after taxes		(3,454)	142		142	(3,312)
Difference from currency translation		(783)		88	88	(695)
<b>Balance at Dec. 31, 2001</b>	<b>(7)</b>	<b>60,987</b>	<b>5,584</b>	<b>(277)</b>	<b>5,307</b>	<b>66,294</b>
Changes in the composition of the Group			(1,586)		(1,586)	(1,586)
Dividends for 2001		(1,539)	(43)		(43)	(1,582)
Unappropriated net income carried forward						
Stock issued on exercise of stock options, warrants and exchange rights		83				83
Loss after taxes		(24,587)	284		284	(24,303)
Difference from currency translation		(3,523)		26	26	(3,497)
<b>Balance at Dec. 31, 2002</b>	<b>(7)</b>	<b>31,421</b>	<b>4,239</b>	<b>(251)</b>	<b>3,988</b>	<b>35,409</b>

(1) Treasury shares are included within marketable securities in the consolidated balance sheets.  
The accompanying notes are an integral part of the consolidated financial statements.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**Summary of Accounting Policies**

**Description of Business and Relationship with the Federal Republic of Germany**

The business of the Deutsche Telekom Group (hereafter referred to as Deutsche Telekom, the Company or the Group) is structured in four divisions: T-Com, T-Systems, T-Mobile and T-Online.

T-Com is one of the largest fixed-network operators in Europe, operating approximately 57.5 million lines including ISDN channels. In Germany, T-Com serves residential customers and small and medium-sized business customers with over 51 million lines including ISDN channels and a broad range of products and services. As a full-service provider, T-Com offers integrated solutions consisting of information technology and telecommunications to approximately 440,000 small and medium-sized companies in Germany. T-Com is present in the markets within Central and Eastern Europe through its shareholdings in MATAV (Hungary), Hrvatske telekomunikacije (Croatia) and Slovenske Telekomunikacije (Slovakia).

T-Systems serves Deutsche Telekom's key account customers both domestically (within Germany) and internationally with comprehensive information technology and telecommunications services and e-business solutions.

Deutsche Telekom bundles its main mobile communications activities in the division T-Mobile. The mobile communications holding company is focused on the growth markets in Europe and the USA. In total, T-Mobile is represented in eight countries around the world with subsidiaries and affiliated companies. The network operators T-Mobile Deutschland GmbH (Germany), T-Mobile Austria GmbH (Austria, hereafter referred to as T-Mobile Austria), T-Mobile UK Ltd. (United Kingdom, hereafter referred to as T-Mobile UK), T-Mobile USA, Inc. (USA, formerly VoiceStream Wireless Corporation, Bellevue, USA, hereafter referred to as T-Mobile USA), Powertel, Inc. (USA, hereafter referred to as Powertel) and Ben Nederland Holding B.V. (hereafter referred to as Ben) are wholly-owned subsidiaries of T-Mobile International AG. The holding company holds a majority investment in the mobile communications provider RadioMobil a.s. (Czech Republic). The company also has minority shareholdings in Russia (MTS) and Poland (PTC).

T-Online is one of the largest European Internet service providers, with more than 12.2 million customers. In line with T-Online's strategy, its foreign subsidiaries T-Online.at (Austria), Ya.com (Spain), T-Online France (France), and T-Online.ch (Switzerland) used the broadband market in 2002 to support their subscriber growth and to extend the reach of their portals. Deutsche Telekom also includes the publishing business of DeTeMedien in the T-Online division.

Other includes all Group units which cannot be allocated to an individual segment. These include the Deutsche Telekom Group headquarters as well as the subsidiaries and shared services assigned to it, such as real estate, billing services, fleet management and the newly established Personnel Service Agency (PSA), as well as various competence centers and other subsidiaries, associated and related companies of the Group.

The Company, Deutsche Telekom AG, was registered with the Commercial Registry of the Bonn District Court (Amtsgericht HRB 6794) on January 2, 1995.

The Federal Republic of Germany's direct and indirect shareholding in Deutsche Telekom at December 31, 2002 amounted to 42.77%. The direct shareholding amounted to 30.75% (1,290,835,401 shares); a further 12.02% (504,590,664 shares) are held by a federal corporation, the Kreditanstalt fuer Wiederaufbau (KfW). The Federal Republic administers its shareholding and exercises its rights as a shareholder through a public law entity, the Bundesanstalt fuer Post und Telekommunikation Deutsche Bundespost (the Federal Agency), which is subject to supervision by the Federal Ministry of Finance (BMF).

The Regulatory Authority for Telecommunications and Posts (the Regulatory Authority) commenced its activities on January 1, 1998. The Regulatory Authority, which is under the authority of the Federal Ministry of

Economics, supervises the telecommunications sector in Germany, and in this capacity regulates the business activities of Deutsche Telekom.

The Federal Republic of Germany is one of Deutsche Telekom's customers; it sources services from the Company at market conditions. The Group provides services to various departments and agencies of the Federal Republic at market prices and terms based on Deutsche Telekom's commercial pricing policies. Services provided to any one department or agency of the Federal Republic do not represent a significant component of Deutsche Telekom's net revenues.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Summary of Significant Accounting Principles**

The annual consolidated financial statements and the management report of the Deutsche Telekom Group have been prepared in accordance with the requirements of the German Commercial Code (Handelsgesetzbuch HGB), referred to as German GAAP below, and German Stock Corporation Law (Aktengesetz AktG). In general, Deutsche Telekom applies the relevant German Accounting Standards (DRS). However, the Company did not apply the valuation method for capital consolidation as required by DRS 4; Deutsche Telekom decided not to apply this standard in order to avoid valuation differences between German GAAP and U.S. GAAP.

In addition to having its shares traded on the Frankfurt and other German stock exchanges, as well as the Tokyo exchange, Deutsche Telekom shares are traded in the form of American Depositary Shares (ADS) on the New York Stock Exchange (NYSE) and the German stock exchanges. Differences between the accounting principles in Deutsche Telekom's consolidated financial statements and those of U.S. GAAP are, in most cases, the result of binding rules of German GAAP which differ from those of U.S. GAAP.

The consolidated financial statements differ from financial statements prepared in accordance with U.S. GAAP. Differences in accounting and valuation principles applied in Deutsche Telekom's financial statements and those of U.S. GAAP are shown in a reconciliation in note (40) et. seq. to the consolidated financial statements.

German GAAP requires only one year of comparative figures for the statement of operations, whereas the SEC requires the two previous years. The SEC also requires three years of cash flow statements and statements of shareholders' equity.

The consolidated balance sheets and the consolidated statements of operations are prepared in accordance with the classification requirements of § 298 HGB, in combination with § 266 and § 275 HGB. The statements of operations are prepared using the total cost method. All amounts shown are in millions of euros ( /EUR). Certain items have been combined in order to make the financial statements more informative and understandable. These items are shown separately in the notes. In the case of changes in presentation, prior-year amounts are reclassified to conform with the current-year presentation. In accordance with § 297 (1) sentence 2 HGB, the consolidated accounts also include a consolidated statements of cash flows and a segment report; in addition, the consolidated accounts also include a consolidated statements of shareholders' equity. In conformity with international practice, reporting begins with the income statement, and the statements of cash flows and the statements of shareholders' equity precede the notes to the consolidated financial statements.

The consolidated financial statements are prepared in accordance with uniform accounting policies. The accounting policies used in the consolidated financial statements differ from those used in the unconsolidated financial statements of the parent company. Such differences, mostly applied to conform with U.S. GAAP, include the following:

Property, plant and equipment leased under contracts for which, in accordance with U.S. GAAP and in contrast to the leasing provisions of tax law, the risks and rewards of ownership have been assumed (excluding sale and lease back transactions) are capitalized. Scheduled depreciation is recorded over the shorter of the estimated useful economic life of the asset or the term of the lease. The present value of payment obligations resulting from future lease payments is included as liabilities.

Interest incurred while items included in property, plant and equipment are under construction has been capitalized as part of the assets' costs.

Accruals for the internal costs of preparing the annual financial statements are not recorded.

Investment grants received are recorded as reductions of the acquisition costs of assets.

**Consolidated Group**

The consolidated financial statements are comprised of the accounts of Deutsche Telekom AG and its subsidiaries.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The subsidiaries, associated companies and other related companies have been included in the consolidated financial statements in accordance with the following criteria:

Subsidiaries are companies in which Deutsche Telekom directly or indirectly has majority voting rights or management control.

Associated companies are companies in which Deutsche Telekom directly or indirectly holds between 20% and 50% of the voting rights and exercises a significant influence. Such companies are generally included in the consolidated financial statements using the equity method.

Companies in which Deutsche Telekom holds less than 20% of the voting rights are carried in the consolidated financial statements at the lower of acquisition cost or market value and classified as Other investments in related companies.

The changes in the composition of the Deutsche Telekom Group in 2002 are presented in the following table:

	<u>Domestic</u>	<u>International</u>	<u>Total</u>
<b>Consolidated subsidiaries</b>			
January 1, 2002	104	253	357
Additions	7	17	24
Disposals	(13)	(14)	(27)
Reclassifications	3	4	7
	—	—	—
December 31, 2002	101	260	361
	—	—	—
<b>Associated companies included at equity</b>			
January 1, 2002	21	29	50
Additions	6	5	11
Disposals	(4)	(2)	(6)
Reclassifications	(1)	(5)	(6)
	—	—	—
December 31, 2002	22	27	49
	—	—	—
<b>Other unconsolidated subsidiaries and other investments in related companies (greater than 5%)</b>			
January 1, 2002	91	48	139
Additions	9	15	24
Disposals	(9)	(16)	(25)
Reclassifications	(2)	1	(1)
	—	—	—
December 31, 2002	89	48	137
	—	—	—
<b>Total</b>			
January 1, 2002	216	330	546
Additions	22	37	59
Disposals	(26)	(32)	(58)
Reclassifications	0	0	0
	—	—	—
December 31, 2002	212	335	547
	—	—	—

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The consolidated financial statements include the individual company financial statements of the parent company, Deutsche Telekom AG, as well as 101 (Dec. 31, 2001: 104) domestic and 260 (Dec, 31, 2001: 253) foreign subsidiaries in which Deutsche Telekom AG has a direct or indirect controlling interest.

The most significant subsidiary consolidated for the first time during 2002 is Ben.

The changes in the company's composition of the Deutsche Telekom Group had the following effects on the consolidated financial statements in 2002:

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Effects on the Company's consolidated statement of operations due to acquisitions in 2001 and 2002 were as follows (millions of \$):

Revenue	3,296
Goods and services purchased	(902)
Personnel costs	(606)
Depreciation and amortization	(2,695)
Other income (expenses)	(1,616)
	<hr/>
<b>Net loss</b>	<b>(2,523)</b>
	<hr/>

Effects on the Company's consolidated balance sheet due to acquisitions in 2002 were as follows (millions of \$):

<b>Assets</b>	
Noncurrent assets	1,302
Current assets, prepaid expenses, deferred charges and deferred taxation	(97)
	<hr/>
	<b>1,205</b>
	<hr/>
<b>Shareholders' equity and liabilities</b>	
Shareholders' equity	(1,002)
Accruals	158
Liabilities and deferred income	2,049
	<hr/>
	<b>1,205</b>
	<hr/>

Main acquisitions:

2002:

Deutsche Telekom AG acquired the remaining shares in T-Systems ITS GmbH (formerly debis Systemhaus) from DaimlerChrysler Services AG on March 4, 2002 via the Deutsche Telekom subsidiary T-Systems International GmbH. The purchase price was EUR 4.7 billion. The goodwill of EUR 2.7 billion generated by this acquisition is amortized over a period of up to ten years on a straight-line basis over the estimated useful life. T-Systems ITS GmbH has been included in the consolidated financial statements of Deutsche Telekom AG since October 2000 as a result of the acquisition of the majority shareholding of 50.1%. In November 2002 T-Systems International GmbH underwent a downstream merger with T-Systems ITS GmbH. At the same time T-Systems ITS GmbH was renamed T-Systems International GmbH.

On September 25, 2002, T-Mobile International AG acquired the remaining 50.0001% of the shares in the mobile communications company Ben from its other shareholders Belgacom, TDC and Gringots (Credit Suisse First Boston) for a purchase price of EUR 1.7 billion and assumption of outstanding shareholder loans of approximately EUR 0.3 billion. Ben provides mobile communications services in the Netherlands. Approximately EUR 1.0 billion of the EUR 1.7 billion of goodwill generated by this transaction was written down as a result of the Company's strategic review. The remaining amount will be amortized over a period of 12 years. The company was fully consolidated as a subsidiary for the first time on September 30, 2002. The effects on the Company's consolidated balance sheet at that date were as follows (in millions of \$):

<b>Assets</b>	
Noncurrent assets	1,971
Current assets, prepaid expenses, deferred charges and deferred taxation	99
	<b>2,070</b>
<b>Shareholders equity and liabilities</b>	
Shareholders equity	1,706
Accruals	16
Liabilities and deferred income	348
	<b>2,070</b>

2001:

On January 15, 2001, Deutsche Telekom acquired 51% of the shares in the Macedonian telecommunications company Makedonski Telekomunikacii A.D., Skopje (referred to as MakTel below) via a subsidiary of MATAV. The acquisition costs amounted to EUR 301.5 million. MakTel was included in the subgroup financial statements of MATAV for the first time in the first quarter of 2001. The goodwill generated, EUR 180.3 million, is being amortized over a period of 20 years.

In April 2001 Deutsche Telekom increased its shareholding in the Czech mobile communications company RadioMobil a.s., Prague (herein referred to as RadioMobil) via Cmobil B.V., Amsterdam, a subsidiary of T-Mobile International AG, Bonn (herein referred to as T-Mobile International). The acquisition



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

costs for this additional 11.77% stake amounted to EUR 598 million. Cmobil's shareholding thus increased to 60.77%. The additional goodwill generated, EUR 444 million, will be amortized over a period of 12 years. RadioMobil was consolidated in full for the first time on April 1, 2001.

On May 31, 2001, Deutsche Telekom acquired 100% of the shares in T-Mobile USA and Powertel for a total purchase price of EUR 39.4 billion including a cash component of EUR 4.9 billion and an initial preferred stock investment in T-Mobile USA amounting to EUR 5.6 billion, which Deutsche Telekom had acquired in September 2000. T-Mobile USA provides communications services in urban areas of the United States on the basis of GSM (Global System for Mobile Communications) technology. Powertel provides communications services mainly in urban areas in the Southeast of the United States on the basis of GSM technology. T-Mobile USA shareholders received for each share of T-Mobile USA common stock either 3.6693 Deutsche Telekom shares and US\$ 15.7262 in cash, 3.6683 Deutsche Telekom shares and US\$ 15.9062 in cash or 3.7647 Deutsche Telekom shares. Each Powertel shareholder received 2.6353 Deutsche Telekom shares for each Powertel share. T-Mobile USA and Powertel were consolidated in full for the first time on May 31, 2001. The consolidation of T-Mobile USA and Powertel generated goodwill totaling EUR 23.6 billion. This is being amortized over a period of up to 20 years. However, the Group recorded a nonscheduled goodwill amortization amounting to EUR 8.3 billion as a result of the strategic review in the second half of 2002. In connection with the acquisition of T-Mobile USA and Powertel, Deutsche Telekom granted rights to purchase a total of 43,619,261 individual no par value Deutsche Telekom shares in exchange for outstanding options for shares in T-Mobile USA and Powertel (exchange rights of Cook Inlet and Eliska Wireless).

On October 25, 2001, Deutsche Telekom AG acquired an additional 16% stake in the capital of the Croatian telecommunications company HT-Hrvatske telekomunikacije d.d., Zagreb, increasing its ownership to 51%, for a purchase price of EUR 507 million. After the acquisition, Deutsche Telekom AG became the majority shareholder and consolidated the company in full in its consolidated financial statements from November 1, 2001. The goodwill generated, EUR 240 million, is being amortized over a period of up to 20 years.

The following pro forma information shows Deutsche Telekom's most important financial data, including the major subsidiaries acquired in 2002 and 2001, as if they had been consolidated at January 1, 2001.

**Pro Forma Information (Unaudited)**

	<u>2002</u>	<u>2001</u>
<b>Net revenue (billions of )</b>		
Reported	53.7	48.3
Pro forma	54.1	51.6
<b>Net loss under German GAAP (billions of )</b>		
Reported	(24.6)	(3.5)
Pro forma	(24.9)	(6.9)
<b>Loss per share under German GAAP ( )</b>		
Reported	(5.86)	(0.93)
Pro forma	(5.93)	(1.85)

At December 31, 2002 and 2001, 77 and 83 subsidiaries, respectively, were not consolidated because they were not material to the net worth, financial position and results of the Deutsche Telekom Group. These subsidiaries accounted for less than 1% of consolidated revenue, results of operations and total assets of the Deutsche Telekom Group.

At December 31, 2002, in accordance with § 311 (1) HGB, 49 (Dec. 31, 2001: 50) companies over which Deutsche Telekom exercises significant influence have been classified as associated companies and are accounted for using the equity method. The remaining 35 (Dec. 31, 2001: 56) associated companies which have little or no effect on the net worth, financial position and results of the Deutsche Telekom Group were classified as Other investments in related companies at acquisition cost less applicable write-downs.

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The full list of investment holdings is filed with the Commercial Registry of the Bonn District Court (HRB 6794). The list is available upon request from Deutsche Telekom AG, Bonn, Investor Relations. Furthermore, the list of investment holdings includes a full list of all subsidiaries which exercise disclosure simplification in accordance with § 264 (3) HGB.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Principal Subsidiaries and Associated Companies**

The principal subsidiaries and associated companies whose revenues and results of operations, together with Deutsche Telekom AG, account for more than 90% of the results of operations and financial position of the Group are shown in the table below:

Name and registered office	Deutsche Telekom share Dec. 31, 2002	Shareholders equity Dec. 31, 2002	Revenue 2002	Income after taxes 2002	Employees 2002 annual average
	(%)		(millions of €)		
<b>Subsidiaries</b>					
<b>T-Mobile Deutschland</b> GmbH, Bonn(5)	100.00	1,447	7,801	3,564	9,226
<b>T-Mobile Holdings</b> Ltd., Borehamwood, United Kingdom(1)(5)	100.00	8,808	3,997	(3,425)	6,283
<b>T-Mobile Austria</b> GmbH, Vienna, Austria(1)(5)	100.00	389	1,034	23	2,675
<b>T-Mobile USA, Inc.</b> , Bellevue, Washington, USA/ <b>Powertel Inc.</b> , Bellevue, Washington, USA(1)(5)	100.00	11,697	6,137	(18,122)	17,290
<b>RadioMobil</b> a.s., Prague, Czech Republic(7)	60.77	389	705	88	2,542
<b>Ben Nederland</b> Holding B.V., Amsterdam(1)(5)	100.00	15	552	(594)	1,379
<b>T-Online International</b> AG, Darmstadt(1)	71.90	5,366	1,584	(465)	1,620
<b>T-Systems International</b> GmbH, Frankfurt a.M	100.00	1,244	3,828	(1,273)	10,938
<b>T-Systems CSM</b> GmbH, Darmstadt(6)	100.00	243	2,131	138	3,974
<b>Detecon International</b> GmbH, Bonn(6)	100.00	76	121	19	261
<b>T-Systems SIRIS</b> S.A.S., Paris, France(6)	100.00	46	237	(136)	333
<b>GMG Generalmietgesellschaft</b> mbH, Münster	100.00	151	2,862	(132)	7,126
<b>DeTeImmobilien</b> , Deutsche Telekom Immobilien und Service GmbH, Münster	100.00	17	771	(70)	5,644
<b>T-Data</b> Gesellschaft für Datenkommunikation mbH, Bonn(1)	100.00	502	565	39	1,110
<b>Kabel Deutschland</b> GmbH, Bonn(1)(10)	100.00	4,601	919	(334)	2,863
<b>MATÁV</b> , Magyar, Távközlési Rt., Budapest, Hungary(1)(4)	59.50	2,180	2,431	280	16,343
<b>Slovenské Telekomunikácie</b> , a.s., Bratislava, Slovakia(1)	51.00	1,131	441	81	9,804
<b>HT-Hrvatske telekomunikacije</b> d.d., Zagreb, Croatia(1)	51.00	1,765	1,001	249	10,773
<b>Associated companies</b>					
<b>MTS</b> , OJSC Mobile TeleSystems, Moscow, Russia(1)(2)(3)(9)	36.20	1,156	998	232	4,990

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<b>PTC, Polska Telefonia Cyfrowa</b> Sp.z o.o, Warsaw, Poland(1)(2)(8)	49.00	285	1,183	116	3,399
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- (1) Consolidated subgroup financial statements
- (2) 2001 financial year
- (3) Indirect shareholding via T-Mobile Deutschland GmbH, Bonn (Deutsche Telekom share: 100%)
- (4) Held via MagyarCom Holding GmbH, Bonn (Deutsche Telekom AG share: 100%)
- (5) Indirect shareholding via T-Mobile International AG, Bonn (Deutsche Telekom share: 100%)
- (6) Indirect shareholding via T-Systems International GmbH, Frankfurt a.M. (Deutsche Telekom share: 100%)
- (7) Indirect shareholding via Cmobil B.V., Amsterdam (Deutsche Telekom indirect share: 92.14%)
- (8) Indirect shareholding via T-Mobile Deutschland GmbH, Bonn; Mediaone International B.V., Eindhoven and Polpager Sp.z o.o., Warsaw (Deutsche Telekom AG indirect share: 100% each)
- (9) Employees at balance sheet date at end of 2001
- (10) Operating businesses sold during first quarter of 2003

### **Consolidation Principles**

**Capital consolidation** is performed following the book value method under German GAAP. Under this method, the purchase consideration for an acquisition is allocated to the assets and liabilities acquired based on their fair values. Any resulting excess of the purchase consideration over the parent's interest in the fair

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

value of net assets acquired is capitalized as goodwill and amortized over its estimated useful life. Negative goodwill from capital consolidation is included under other accruals.

Profits or losses generated by subsidiaries during their period of affiliation with the Group are included in retained earnings; furthermore, they include the effects of consolidation and the net income (loss) of subsidiaries.

If, in the course of capital increases of subsidiaries and associated and related companies, shares are issued to third-party shareholders, without the involvement of Deutsche Telekom, the resulting added value for Deutsche Telekom is shown, in cases of cash capital increases, as income in the income statement; in cases of capital increases for noncash contributions, it is only shown as such if the added value exceeds a given level of goodwill acquired by the subsidiary or associated or related company in the course of the capital increase.

Revenue, income and expenses as well as receivables and liabilities between the consolidated companies are eliminated. **Intercompany profits and losses** and income effects from the **consolidation of intercompany debt** are eliminated in the consolidated financial statements.

The consolidated balance sheets include deferred taxes resulting from the effects of consolidation, provided the tax expense is expected to reverse in later years when taxes will be paid, except where the effects of consolidation relate to the parent company during the periods prior to the end of 1995, when it was essentially exempt from taxation.

The investments in associated companies included **at equity** are accounted for using the book value method; equity is calculated by applying local principles of valuation, as permitted by § 312 (5), sentence 2 HGB. The principles used for full consolidation are also applied in treating the differences resulting from the initial consolidation.

**Joint ventures** are included using the equity method.

**Foreign Currency Translation**

In the individual company financial statements, foreign currency receivables, cash in banks and liabilities are translated at the exchange rate applicable on the transaction date. Unrealized foreign currency losses due to exchange rate fluctuations through the balance sheet date are recognized in the income statement while unrealized foreign currency gains are not recognized. Where foreign currency items have been hedged by forward exchange contracts, they are valued at the corresponding hedge rate.

Currency translation of foreign subsidiaries is made in accordance with the functional currency method. Thus, the functional currency is the currency in which the foreign subsidiary performs its principal operations. The activities and financial structure as reported in this currency should be reflected in the Group accounts. Generally, the functional currency of dependent subsidiaries is identical with that of the parent company. The currencies of dependent subsidiaries are translated according to the temporal method. However, the functional currency of independent subsidiaries is the local currency. Currently all consolidated foreign subsidiaries of Deutsche Telekom conduct their operations independently of the parent company; the currencies are therefore translated according to the modified current rate method. In the consolidated financial statements, the translation of all items shown in balance sheets of foreign subsidiaries from foreign currencies into euros is performed using the average rate on the balance sheet date. Gains and losses resulting from translation are recorded, without affecting income, in the cumulative translation adjustment account. The income statements of foreign subsidiaries are translated at the average annual exchange rates.

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The exchange rates of certain significant currencies are as follows:

	Annual average rate			Spot rate	
	2002	2001	2000	Dec. 31, 2002	Dec. 31, 2001
		( )		( )	
100 Swiss Francs (CHF)	68.1599	66.2063	64.2701	68.7334	67.5494
100 Czech Koruna (CZK)	3.2485	2.9092	2.8011	3.1817	3.1309
1 Pound Sterling (GBP)	1.5910	1.6076	1.6423	1.5364	1.6418
100 Croatian Kuna (HRK)	13.4919	13.3685	13.0896	13.3734	13.6055
100 Hungarian Forints (HUF)	0.4117	0.3904	0.3850	0.4239	0.4079
100 Japanese Yen (JPY)	0.8478	0.9170	1.0050	0.8033	0.8644
100 Malaysian Ringgit (MYR)	27.9362	29.3934	28.5882	25.0772	29.8263
100 Philippine Pesos (PHP)	2.0845	2.1913	2.4585	1.7999	2.1973
100 Polish Zloty (PLN)	25.9930	27.2201	24.9595	24.9994	28.6050
1 Russian Ruble (RUB)	0.0338	0.0383	0.0386	0.0298	0.0372
100 Singapore Dollars (SGD)	59.2270	62.5594	62.9966	55.3403	61.2145
100 Slovak Koruna (SKK)	2.3428	2.3099	2.1282	2.4143	2.3377
1 U.S. Dollar (USD)	1.0616	1.1168	1.0863	0.9529	1.1334

**Accounting and Valuation**

**Net revenues** consist of goods and services sold in connection with the ordinary business activities of Deutsche Telekom. Net revenues are recorded net of VAT and sales-related reductions. They are recognized in the accounting period concerned in accordance with the realization principle. Revenue was generated in the individual divisions as follows:

*T-Com*

T-Com provides customers with narrow and broadband access to its fixed-line network. It also sells, leases and services telecommunications equipment to its customers and provides other ancillary telecommunications services. T-Com recognizes service revenues when the services are provided in accordance with contract terms. The revenue and related expenses associated with the sale of telecommunications equipment and accessories is recognized when the products are delivered and provided there are no unfulfilled company obligations that affect the customer's final acceptance of the arrangement. Revenue from rentals and operating leases is recognized monthly as the fees accrue.

*T-Systems*

## Telecommunication Services

Telecommunication services include network services, carrier services, hosting and ASP services and broadcast services. Contracts for network services, which consist of the installation and operation of communication networks for customers, have an average duration of approximately three years. Revenues for voice, billed on a per minute basis, and data services, billed on a bandwidth basis, under such contracts are recognized when used by the customer. Carrier services revenue and Hosting and ASP Services revenues are recognized as the services are provided.

## Information Technology Services and Consulting

The terms of information technology service contracts generally range from less than one year up to ten years. Revenue from outsourcing contracts reflects the extent of actual services delivered in the period in accordance with the terms of the contract. Revenue from time and material service contracts is recognized as the services are provided. Revenue from systems integration contracts requiring the delivery of unique products and/or services is recognized using the completed contract method. These projects are generally covered by one of the following types of contracts: fixed price, milestone or cost-related contracts. For fixed price contracts revenue is generally recognized when a project is completed and accepted by the customer. For milestone contracts revenue is recognized at the time a milestone is achieved and approved by the customer. Revenue for cost-related contracts is recognized similar to time and material service contracts. Revenue from maintenance is recognized over the contractual period or as the services are performed.

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In some of the Company's service contracts, Deutsche Telekom performs the service prior to billing the customer. This situation may lead to unbilled accounts receivable for Computing Services and Telecommunication Services which are included as revenues in the consolidated statements of operations.

Revenue from hardware sales or sales-type leases is recognized when the product is shipped to the customer and provided there are no unfulfilled company obligations that affect the customer's final acceptance of the arrangement. Any cost of these obligations is accrued when the corresponding revenue is recognized. Revenue from rentals and operating leases is recognized monthly as the fees accrue.

The Company enters into transactions that include multiple element arrangements, which may include any combination of hardware, services or software. These arrangements and stand-alone software arrangements may also involve any combination of software maintenance, software technical support or unspecified software upgrades. When some elements are delivered prior to others in an arrangement, revenue is deferred until the delivery of the last element.

*T-Mobile*

Mobile revenues include revenues from provision of mobile services, customer activation fees and sales of mobile handsets and accessories. Mobile services revenues include monthly recurring charges and charges for special features, airtime charges, and roaming charges billed to T-Mobile customers, as well as other mobile operators. Mobile services revenue is recognized based upon minutes of use and contracted fees, net of credits and adjustments for service discounts. The revenue and related expenses associated with the sale of mobile telephones, wireless data devices and accessories are recognized when the products are delivered and accepted by the customer.

*T-Online*

T-Online revenues consist primarily of revenues from subscriber fees, charges for advertising and e-commerce, provider fees from content hosting, income from the provision of business homepage services for business clients and from cooperative arrangements with various content providers. Subscriber fees, consisting primarily of basic monthly charges for T-Online services and Internet access as well as use-related fees, are recognized as revenue in the period the service is provided. Advertising revenues are recognized in the period that the advertisements are exhibited. Transactions revenues are recognized upon notification from the customer that qualifying transactions have occurred and collection of the resulting receivable is reasonably assured.

**Research and development costs** are expensed in full as incurred and amounted to approximately EUR 0.9 billion, EUR 0.95 billion and EUR 0.7 billion for the years ended December 31, 2002, 2001 and 2000, respectively.

**Pension costs** for defined benefit plans are actuarially computed using the Projected Unit Credit Method, which is consistent with SFAS No. 87, and are shown in accordance with SFAS 132. This method presupposes the total present value of the benefit obligations accumulated during the reporting period and takes into consideration the expected increases in wages and salaries and in retirement benefits. By contrast, the minimum accrual method in accordance with § 6a of the German Income Tax Act (*Einkommensteuergesetz, EStG*) is aimed at the recognition of the expense over the employees' entire working lives and does not take the expected increases in wages and salaries and retirement benefits into account (cf. (27) accruals for pensions and similar obligations).

Total pension costs for the current year include standard costs for benefit obligations acquired in the financial year (service cost), interest cost and amortization of actuarial gains and losses, less the return on assets to cover pension obligations. In accordance with U.S. GAAP, if the measurement of pension obligations under SFAS No. 87 results in the need to disclose an additional minimum liability, this special item is charged directly to other comprehensive income (OCI). The consolidated financial statements in accordance with German GAAP do not include an equivalent shareholders' equity position; changes in additional minimum liability are expensed.



**Marketing expenses** are expensed as incurred.

**Income tax expense** includes current income taxes payable as well as deferred taxes. Deferred income taxes are recorded for the expected future tax effects attributable to temporary differences in the balance

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sheets prepared for tax reporting and for financial reporting purposes, except for the effects of those differences that are not expected to reverse in the foreseeable future or within expected net operating loss carryforward periods. Such differences may arise at the individual taxable entity level as well as in consolidation. Deferred taxes on temporary differences relating to Deutsche Telekom AG have not been included in the consolidated financial statements for periods prior to January 1, 1996, as Deutsche Telekom AG was not taxable prior to January 1, 1995, and benefited from an essentially complete exemption from tax in 1995.

**Earnings per share** for each period are calculated by dividing net income (loss) by the weighted average number of ordinary shares outstanding during that period. The weighted average number of ordinary shares in 2002 and 2001 was ascertained after giving effect to the issuance of shares as part of the acquisition of T-Mobile USA/Powertel including those shares held in a trust for further issuance and the commencement of trading of the common shares and ADRs of the Company on June 4, 2001, in Frankfurt am Main.

Purchased **intangible assets** including UMTS and U.S. mobile communications licenses are carried at acquisition cost and are amortized on a straight-line basis over their estimated useful lives. Acquired goodwill, including goodwill resulting from capital consolidation, is amortized on a straight-line basis over its estimated useful life.

Deutsche Telekom carries out impairment tests for subsidiaries for which a considerable level of goodwill is recorded. These tests are based on the calculation of the goodwill for the respective company and are carried out using the discounted cash flow method.

As permitted by Postreform II, **property, plant and equipment** transferred to Deutsche Telekom AG on January 1, 1995, was recorded in the opening balance sheet of Deutsche Telekom AG at fair market values at that date. However, due to the short period of time that had elapsed since the measurement date for property, plant and equipment acquired since January 1, 1993, their carrying amount as at December 31, 1994, was recognized as the future historical cost basis. The remaining useful lives and the depreciation methods applicable to these assets were not changed. The fair market values shown in the opening balance sheet have been carried forward as the acquisition costs.

Other property, plant and equipment is carried at acquisition or production cost, less scheduled depreciation. Construction costs include directly allocable costs, an appropriate allocation of material and production overhead and interest accruing during construction. General administration costs are not capitalized.

Nonscheduled depreciation is provided for when events or circumstances occur indicating an impairment in the value of assets. Such events or circumstances include prolonged adverse changes in the business environment or in assumptions or expectations considered at the time of initial acquisition.

Depreciation of noncurrent assets is generally carried out using the straight-line method over the following estimated useful lives:

	<u>Years</u>
Intangible assets	3 to 22
Goodwill	3 to 20
Buildings	25 to 30
Shop improvements and window displays	8
Telephone facilities and terminal equipment	3 to 10
Data communications equipment, telephone network and ISDN switching equipment, transmission equipment, radio transmission equipment and technical equipment for broadband distribution networks	4 to 10

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Broadband distribution networks, outside plant networks and cable conduit lines	15 to 35
Telecommunications power facilities	3 to 10
Other equipment, plant and office equipment	3 to 20

Additions to real estate are depreciated beginning in the month the building is placed into service. For assets other than buildings acquired in the first half of a year, a full year of depreciation is provided in the year of acquisition and, for those assets acquired in the second half of the year, a half year of depreciation is provided.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Items with a low acquisition cost are expensed in the year of purchase.

Maintenance and repairs are expensed as incurred.

Noncurrent assets sold or otherwise disposed of are written off at their relevant carrying amount (acquisition or construction cost minus cumulative depreciation). A gain or loss is recognized in income for the difference between the proceeds from the sale and the carrying amount of the asset concerned.

**Financial assets** are valued at the lower of cost or market value. Low-interest or non-interest bearing loan receivables are recorded at net present value. Nonscheduled write-downs are provided for only if impairment of financial assets is assumed to be permanent. In measuring impairments, Deutsche Telekom uses the actual market prices, if available, or other valuation methods based on information available from the investee.

**Raw materials and supplies**, and **merchandise** purchased and held for resale are valued at acquisition cost, while **work in process and finished goods** are stated at production cost. Based on normal capacity utilization, construction cost includes directly allocable costs such as material and labor costs as well as special production costs plus an appropriate pro rata allocation of material and production overhead and straight-line depreciation. General administration and selling costs, social amenities expenses as well as voluntary benefits to personnel including pensions are not included in construction cost. The carrying amount of inventories is reduced to the lower of cost or market value at the balance sheet date. Further adjustments to these carrying amounts are recorded for obsolescence. For a detailed breakdown of inventory components refer to note (15) below.

**Receivables and other assets** are shown at their nominal value. Known individual risks are accounted for through appropriate individual valuation adjustments, and general credit risks through general valuation adjustments of receivables. Low-interest and non-interest bearing items with more than one year remaining to maturity are discounted.

**Marketable securities** are stated at the lower of cost or market value at the balance sheet date.

**Stock options** granted in the course of a contingent capital increase are shown in the balance sheet at the date the options are exercised, not at the date they are granted. At the time the options are exercised, the amount received by the Company is recorded at the value of the corresponding nominal capital increase in the capital stock and at the value of an additional amount in additional paid-in capital, in accordance with § 272 (2) No. 1 HGB.

**Accruals for pensions and similar obligations** are based on obligations to non-civil servants. They are calculated using actuarial methods in accordance with the internationally accepted Projected Unit Credit Method, which is consistent with U.S. GAAP (SFAS No. 87), and are shown in accordance with SFAS No. 132.

Deutsche Telekom is obliged to make contributions to a pension fund for current and former civil servant employees in annual amounts established by Postreform II, which came into force in 1995, rather than by annual actuarial valuations. The contribution amounts currently due in each period are recognized as an expense in the current period.

**Provisions for taxes and other accruals**, including those for contingent losses and environmental liabilities, are recorded in line with prudent commercial practice. Sufficient allowance was made for all foreseeable risks when assessing these provisions and accruals.

**Deferred taxes** are calculated for the expected tax effects of temporary differences between the balance sheets prepared for financial reporting and tax reporting purposes, as well as for the temporary differences arising from consolidation entries. Deferred taxes are netted and either a net deferred tax asset or net deferred tax liability is recorded separately under tax accruals. For purposes of computing deferred taxes, Deutsche

Telekom uses a combined tax rate for domestic companies, covering German corporate income taxes, trade taxes (at an average German national rate), and the solidarity surcharge (*Solidaritätszuschlag*); the respective local tax rate is used for foreign companies.

**Cost accruals** are only made by Deutsche Telekom when there is an obligation to carry such liabilities on the balance sheet pursuant to § 249 (1) HGB. This refers mainly to accruals for costs of maintenance related to the financial year, but only incurred within the first three months of the following year.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Major **accruals**, with the exception of pensions and similar obligations as well as Civil Service Health Insurance Fund accruals for future shortfalls, are not discounted.

**Liabilities** are recorded at their repayment amount. In instances where the repayment amount of a liability is greater than the principal amount, the difference is recorded as an asset and recognized as an adjustment to interest expense over the term of the liability.

Unrealized losses relating to **derivative financial instruments** that do not qualify for hedge accounting are recognized when incurred, whereas unrealized gains are deferred until realized.

The preparation of consolidated financial statements in accordance with German GAAP requires the Company to make estimates and assumptions that affect the reported carrying amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses recognized during the reporting period. Actual results could differ from those estimates.

**New German Accounting Standards (GAS)**

**GAS 10 Deferred Taxes in Consolidated Financial Statements** sets out the procedures for accounting for deferred taxes in consolidated financial statements. Deferred taxes should be recognized on timing differences relating to items dealt with through the profit and loss account and which, on reversal in future periods, are expected to result in tax expenses and tax reductions. Quasi-permanent differences should also be treated as timing differences. A deferred tax asset should be recognized on tax loss carryforwards and tax credits to the extent that it is sufficiently probable that the tax benefits from the tax loss carryforwards can be recovered. The Company has not yet decided if it will adopt GAS 10 during 2003. However, the adoption of GAS 10 during 2003 would result in a substantial increase in deferred tax assets and stockholders' equity.

**GAS 11 Related Party Disclosures** requires capital market oriented parent enterprises (*kapitalmarktorientierte Gesellschaften*) to report on relationships with related parties. Related parties are individuals or legal entities which have the ability to control the reporting enterprise (or one of its subsidiaries) or which can exercise, either directly or indirectly, significant influence over the reporting enterprise (or one of its subsidiaries). Significant transactions with related parties should be disclosed in the notes to the consolidated financial statements either as an absolute amount or as a proportion of net sales. Receivables and payables (as well as contingent receivables and payables) and pricing policies should also be disclosed. This standard is effective for financial years beginning after June 30, 2002. Since the adoption of GAS 11 affects disclosure only, the adoption of GAS 11 will not have a material impact on our consolidated financial statements.

**GAS 12 Non-current Intangible Assets** sets out the rules for the recognition and measurement of non-current intangible assets. An intangible asset purchased for consideration should be measured at cost. If the useful life of an intangible asset is limited in time, the acquisition cost should be amortized systematically over its estimated useful life. A review should be performed at each reporting date to determine whether the intangible asset has suffered an impairment in value. Irrespective of whether the useful life of an intangible asset is limited or not limited in time, an intangible asset should be written down to its fair value if this is lower than the carrying amount. The impairment loss should be reversed if the reasons for the impairment loss no longer exist. This standard is effective for financial years beginning after December 31, 2002. The Company does not expect that the implementation of GAS 12 will have a material impact on its consolidated financial statements.

**GAS 13 Consistency Principle and Correction of Errors** stipulates that accounting policies be applied consistently from one period to the next. Departure from the consistency principle is only permissible in justified exceptional circumstances. The effect of a change in accounting policies and in consolidation method should be computed retrospectively. Pro forma disclosures should be presented for the previous years' figures. This standard is effective for financial years beginning after December 31, 2002. The company does not expect that the implementation of GAS 13 will have a material effect on its consolidated financial statements.



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTES TO THE CONSOLIDATED STATEMENTS OF OPERATIONS****(1) Net Revenue**

	For the year ended December 31,		
	2002	2001 <sup>(1)</sup>	2000 <sup>(1)</sup>
	(millions of )		
T-Com	25,422	25,028	24,455
T-Systems	7,793	8,316	6,021
T-Mobile	18,229	12,994	8,994
T-Online	1,672	1,338	1,038
Other	573	633	431
	<b>53,689</b>	<b>48,309</b>	<b>40,939</b>

(1) Due to the repositioning of the divisions T-Com and T-Systems, the prior-year figures for T-Com, T-Systems and Other have been adjusted in line with the new structure.

**Revenue by geographic area:**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Domestic	35,288	35,107	33,178
International	18,401	13,202	7,761
	<b>53,689</b>	<b>48,309</b>	<b>40,939</b>
Breakdown of international net revenue:			
European Union (excl. Germany)	6,836	6,088	5,023
Rest of Europe	5,067	3,787	2,266
North America	6,166	3,066	231
Latin America	74	85	43
Other	258	176	198
	<b>18,401</b>	<b>13,202</b>	<b>7,761</b>

The percentage of the individual revenue segments in relation to net revenue is as follows:

Net revenue increased by EUR 5,380 million or 11.1% over the previous year. The changes in the composition of the Deutsche Telekom Group resulted in a revenue increase of EUR 3,296 million or 6.8%.



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The increase at T-Com over the previous year is mainly attributable to the first time consolidation of Hrvatske telekomunikacije (Croatia) in October 2001. In Germany, the increase in access revenues more than offsets the decrease in call revenues. Price cuts and direct interconnection between mobile communications carriers and competitors had a negative impact on revenue from the carrier services business.

The decrease at T-Systems is mainly attributable to the difficult economic situation. Certain key account customers have postponed large-scale IT and telecommunications projects.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The increase at T-Mobile is partly attributable to changes in the composition of the Group and partly to increased subscriber numbers.

Growth in access and non-access business had a positive impact on revenue at T-Online.

**(2) Changes in Inventories and Other Own Capitalized Costs**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Change in work in process inventories	(289)	(7)	161
Own capitalized costs	823	886	703
	<b>534</b>	<b>879</b>	<b>864</b>

Own capitalized costs relate primarily to planning and construction services. They include interest incurred during the construction period in the amount of EUR 39 million (2001: EUR 65 million; 2000: EUR 64 million).

**(3) Other Operating Income**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Reversal of accruals	791	1,139	386
Income from the disposition of noncurrent assets (including sale of investments)	818	1,584	5,928
Income from reversal of valuation adjustments (including asset-backed securities)	556	288	125
Cost reimbursements	388	255	305
Foreign currency transaction gains	222	533	309
Insurance compensation	77	46	51
Refund of value-added tax (§ 15a UStG)	68	85	169
Income from rental and lease agreements	41	32	11
Income from disposition of marketable securities	1	1,967	
Income from capital increases of subsidiaries and associated companies			2,887
Other income	939	690	831
	<b>3,901</b>	<b>6,619</b>	<b>11,002</b>

The decrease in income from the reversal of accruals is mainly attributable to the inclusion in the prior-year figure of income from the reversal of accruals for real estate risks which were previously calculated as lump sums (EUR 350 million), and which was not recorded in 2002.

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Income from the disposition of noncurrent assets amounted to EUR 818 million. Of this figure, approximately EUR 200 million relates to the sale of Satelindo and EUR 300 million to the sale of additional shares in T-Online. The decrease in comparison with the previous year relates mainly to the non-recurrence of proceeds from the sale of the Baden-Wuerttemberg regional cable company (EUR 912 million).

The decrease in income from the disposition of marketable securities is mainly attributable to the proceeds from the sale of the shares held in Sprint Corporation, Kansas City, USA, amounting to EUR 1,954 million in 2001.

Of the total amount of other operating income, EUR 1,342 million (2001: EUR 1,897 million; 2000: EUR 611 million) relates to income recognized on transactions consummated in prior years.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(4) Goods and Services Purchased**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Goods purchased	4,671	4,397	4,075
Services purchased	9,747	9,080	7,875
of which: network access charges, Germany	1,967	2,174	1,985
of which: international network access charges	3,905	3,268	2,819
of which: other services	3,875	3,638	3,071
	<b>14,418</b>	<b>13,477</b>	<b>11,950</b>

The level of goods and services purchased increased by EUR 941 million or 7% compared with 2001. Of this increase, changes in the composition of the Deutsche Telekom Group account for EUR 902 million. Excluding the effects of the changes in the composition of the group, goods and services purchased remained at the same level as in the previous year. This is mainly attributable despite organic revenue growth to the lower level of terminal equipment purchased, the decrease in revenue from business with domestic carriers and the more favorable purchasing conditions for international network capacities.

**(5) Personnel Costs/ Average Number of Employees**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
<b>Wages and salaries:</b>	<b>10,467</b>	<b>9,313</b>	<b>7,470</b>
Social security contributions and expenses for pension plans and benefits:			
Social security costs	1,340	1,147	861
Pension costs <sup>(1)</sup>	1,497	1,486	1,220
Health care expenses	176	168	167
	<b>13,480</b>	<b>12,114</b>	<b>9,718</b>

**Number of Employees (Average for the Year)**

	For the year ended December 31,		
	2002	2001	2000
	Number	Number	Number
Civil servants	52,961	56,707	65,217
Salaried employees (excl. civil servants)	202,935	184,953	139,815

<b>Total Deutsche Telekom Group</b>	<b>255,896</b>	<b>241,660</b>	<b>205,032</b>
	<hr/>	<hr/>	<hr/>
Trainees/ student interns	9,869	8,147	6,826

(1) Expenses are incurred from net periodic pension costs plus the change in additional minimum liability which affects net income (loss).

Personnel costs increased by EUR 1,366 million or 11.3% in 2002 to EUR 13,480 million. EUR 0.6 billion relates to changes in the composition of the Deutsche Telekom Group and EUR 0.3 billion to restructuring expenses, in particular at T-Systems.

Furthermore, collective bargaining agreements to adjust wages and salaries to bring them in line with market conditions and to promote performance, and the structural change with the assignment of personnel in higher value positions, contributed to the increase in personnel costs.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(6) Depreciation and Amortization**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Amortization of intangible assets	27,355	5,743	2,233
of which: amortization of goodwill	13,108	3,663	1,247
of which: amortization of UMTS and U.S. mobile communications licenses	13,244	1,414	381
Depreciation of property, plant and equipment	9,525	9,478	10,758
	<b>36,880</b>	<b>15,221</b>	<b>12,991</b>

Of the total depreciation and amortization in 2002, nonscheduled depreciation and amortization related to the following assets:

	2002
	(millions of )
<b>Intangible assets</b>	<b>21,451</b>
of which: UMTS license at T-Mobile UK	2,165
of which: U.S. mobile communications licenses	9,384
of which: goodwill	9,865
<b>Property, plant and equipment</b>	<b>848</b>
of which: buildings	249
of which: submarine cables North Atlantic/Pacific	228
of which: property, plant and equipment at T-Systems	245
	<b>22,299</b>

Depreciation and amortization increased during 2002 by EUR 21,659 million to EUR 36,880 million.

The increase in amortization of intangible assets is mainly attributable to the write-downs on goodwill at T-Mobile USA (EUR 8,288 million), Ben (EUR 958 million) and SIRIS at T-Systems (EUR 473 million) made as a result of the strategic review in the third quarter of 2002. In addition, write-downs were made on the mobile communications licenses of T-Mobile USA (EUR 9,384 million) and the UMTS license of T-Mobile UK (EUR 2,165 million). In total, the write-downs on intangible assets resulting from the strategic review amounted to EUR 21,268 million.

Changes in the composition of the Deutsche Telekom Group in particular generated an increase in scheduled depreciation and amortization of EUR 1.7 billion. Most of this increase is attributable to the inclusion of T-Mobile USA in Deutsche Telekom's consolidated financial statements for the full financial year. Overall, as a result of changes in the composition of the Deutsche Telekom Group, scheduled amortization of goodwill increased by EUR 0.7 billion, amortization of UMTS and U.S. mobile communications licenses by EUR 0.5 billion and depreciation of property, plant and equipment by EUR 0.5 billion.



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(7) Other Operating Expenses**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Marketing expenses	2,204	1,896	1,967
Advertising gifts and commissions	1,645	1,329	794
Rental and leasing expenses	1,732	1,213	766
Losses on accounts receivable and provision for doubtful accounts	1,677	1,225	723
Maintenance and repairs	1,282	1,133	843
Legal and consulting fees	746	695	591
Other employee-related costs	558	598	493
Postal charges	493	486	481
Losses on disposition of noncurrent assets (including sale of investments)	390	478	1,132
Administrative expenses	327	314	217
Foreign currency transaction losses	310	333	241
Provisions	296	391	611
Travel and transport expenses	283	290	241
License and concession expenses	203	197	116
Utilities	160	129	77
Telephone charges	137	94	15
Other expenses	1,667	1,350	1,116
	<b>14,110</b>	<b>12,151</b>	<b>10,424</b>

Of the EUR 1,959 million increase in other operating expenses over the previous year, EUR 1,334 million relates to changes in the composition of the Deutsche Telekom Group, of which T-Mobile USA accounts for EUR 1,047 million.

The increase of EUR 624 million in marketing expenses, advertising gifts and commissions is mainly attributable to the first full-year consolidation of T-Mobile USA. Rental and leasing expenses increased by EUR 519 million over the previous year. This development is mainly attributable to changes in the composition of the Deutsche Telekom Group within T-Mobile. Losses on accounts receivable and provisions for doubtful accounts increased by EUR 452 million, predominantly at Deutsche Telekom AG. This relates mainly to the discount for credit risks from the sales of receivables in the asset-backed securitization programs.

Of the total amount of other operating expenses, EUR 463 million (2001: EUR 534 million, 2000: EUR 1,208 million) relates to expenses recognized on transactions consummated in prior years.

**(8) Financial Income (Expense), Net**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Dividend income from investments	41	107	147



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Results related to companies accounted for under the equity method (including amortization of goodwill)	(430)	(547)	1,890
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Income/(loss) related to associated and related companies</b>	<b>(389)</b>	<b>(440)</b>	<b>2,037</b>
Income from debt securities and long-term loan receivables	171	152	487
Other interest and similar income	1,781	408	511
Interest and similar expense	(6,000)	(4,698)	(4,095)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net interest income (expense)</b>	<b>(4,048)</b>	<b>(4,138)</b>	<b>(3,097)</b>
<b>Write-downs on financial assets and marketable securities</b>	<b>(1,585)</b>	<b>(770)</b>	<b>(170)</b>
	<u>          </u>	<u>          </u>	<u>          </u>
	<b>(6,022)</b>	<b>(5,348)</b>	<b>(1,230)</b>
	<u>          </u>	<u>          </u>	<u>          </u>

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net financial expense in 2002 increased by EUR 674 million over the previous year, mainly as a result of further valuation adjustments on the net carrying amount of the investment in France Telecom, amounting to a total of EUR 0.6 billion, and on other investments in noncurrent securities of EUR 0.4 billion. Results related to associated and related companies and net interest expense improved, however. Results related to associated and related companies improved by EUR 51 million over the previous year, mainly as a consequence of the decrease in expenses (including the amortization of goodwill) relating to investments in associated companies, which were particularly high in the previous year. The decrease in net interest expense is largely attributable to the reversal of interest rate derivatives which were no longer necessary.

**(9) Extraordinary Income (Loss)**

In 2000, this item represented expenses relating to the initial public offering of T-Online International AG and the planned initial public offering of T-Mobile International AG.

**(10) Taxes**

Breakdown of income/(loss) before taxes:

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Germany	1,034	2,953	8,291
International	(27,820)	(5,457)	(1,958)
	<b>(26,786)</b>	<b>(2,504)</b>	<b>6,333</b>

Breakdown of tax expense (benefit):

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Income taxes	(2,847)	751	194
Other taxes	364	57	124
	<b>(2,483)</b>	<b>808</b>	<b>318</b>

Breakdown of the Group's income taxes, Germany and international:

	For the year ended December 31,		
	2002	2001	2000

	(millions of )		
Current taxes			
Germany	132	686	207
International	190	91	35
Deferred income taxes			
Germany	(150)	(30)	(57)
International	(3,019)	4	9
	<b>(2,847)</b>	<b>751</b>	<b>194</b>

The combined statutory income tax rate, currently 39%, includes corporate income taxes at a rate of 25%, the solidarity surcharge of 5.5% on corporate income tax (*Solidaritätszuschlag*) and trade taxes at an average German national rate.

The Group's loss before taxes increased to EUR 26.8 billion. The resulting income tax benefit amounts to EUR 2.8 billion, compared with an expense of EUR 0.8 billion in the previous year. This effect was mainly attributable to the reversal of deferred tax liabilities relating to the nonscheduled amortization of mobile communications licenses of T-Mobile USA/Powertel, which generated a deferred tax benefit of EUR 3.0 billion. In 2002, the Federal Finance Court confirmed Deutsche Telekom's legal position in a legal

**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

dispute concerning Deutsche Telekom AG's recognition of goodwill for tax reporting purposes. The amortization of tax deductible goodwill to be applied to the prior tax years 1996-1999 results in an income tax reduction of approximately EUR 1.0 billion for Deutsche Telekom AG. In addition, amortization of goodwill increases net operating loss carryforwards (corporate income tax and trade tax) for the years 2000-2002 by EUR 2.2 billion (EUR 741 million per year). However, the capitalization of tax deductible goodwill results in an additional expense of EUR 0.2 billion for wealth tax and trade capital tax for the years 1996 and 1997, which resulted in the increase in other taxes.

Furthermore, deferred taxes result primarily from temporary differences between income determined under German GAAP and under applicable tax law. On the basis of the existing net operating loss carryforwards in the Deutsche Telekom consolidated tax group, the parent company will not show any income taxes on the current taxable result until the net operating loss carryforwards have been fully utilized. The deferred taxes of the parent company and the integrated companies which will offset each other over the expected period of utilization of the net operating loss carryforwards were released in 2002.

Differences between actual income taxes benefit of EUR 2,847 million for 2002 (2001: expense of EUR 751 million, 2000: expense of EUR 194 million) and the imputed, expected corporate income tax expense (computed using the statutory corporate income tax rate for the parent company (combined income tax rate) of 39% are as follows:

	<b>For the year ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
	(millions of )		
Expected corporate income tax at the tax rate applicable for the parent company	(10,447)	(977)	2,723
Increase (decrease) in income tax due to:			
Reduction of the group's results without tax effect	11,027	2,896	1,497
Increase in the group's results without tax effect	(435)	(966)	(3,576)
Group results not subject to the German rate of taxation	(2,878)	(491)	(546)
Permanent and semi-permanent differences between the balance sheets prepared for financial reporting and tax reporting purposes	(34)	611	(640)
Other differences between the balance sheets prepared for financial reporting and tax reporting	(323)	0	0
Trade tax (e.g. long-term debt)	247	216	180
Effect of domestic losses	386	(1,186)	370
Effects of changes in tax law / corrections due to losses	(361)	676	167
Other	(29)	(28)	19
<b>Income taxes</b>	<b>(2,847)</b>	<b>751</b>	<b>194</b>
Effective income tax rate	11%	(30)%	3.1%

At December 31, 2002, Deutsche Telekom had net operating loss carryforwards affecting corporate income tax and similar carryforwards amounting to approximately EUR 22,198 million and trade tax net operating loss carryforwards amounting to approximately EUR 6,448 million. With the exception of non-German net operating loss carryforwards of EUR 11,432 million, which mainly will expire between 2008 and 2022, these net operating loss carryforwards have an unlimited carry forward period under current German and local tax law.

**(11) (Income) Losses Attributable to Minority Shareholders**

(Income) losses applicable to minority shareholders includes EUR 390 million (2001: EUR 322 million; 2000: EUR 189 million) in gains and EUR 106 million (2001: EUR 180 million; 2000: EUR 100 million) in losses. The gains in 2002 relate mainly to MATAV and Hrvatske telekomunikacije. The losses relate mainly to T-Online International AG.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTES TO THE CONSOLIDATED BALANCE SHEET****(12) Intangible Assets**

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>Net carrying amount</b>	
	<b>(millions of )</b>	
Concessions, industrial and similar rights and assets, and licenses in such rights and assets	23,837	39,254
Goodwill	29,436	40,597
Advance payments	129	200
	<b>53,402</b>	<b>80,051</b>

The decrease of EUR 26.6 billion in intangible assets to EUR 53.4 billion is mainly attributable to the scheduled and nonscheduled amortization of goodwill and mobile communications licenses as a result of the strategic review in the third quarter of 2002.

This write-down completely offset the EUR 2.7 billion and EUR 1.7 billion increases to intangible assets during 2002, arising from the acquisition of the remaining shares of T-Systems ITS GmbH (formerly debis Systemhaus GmbH) and Ben, respectively.

The development of intangible assets is shown in the table of consolidated noncurrent assets.

**(13) Property, Plant and Equipment**

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>Net carrying amount</b>	
	<b>(millions of )</b>	
Land and equivalent rights, and buildings including buildings on land owned by third parties	11,362	13,063
Technical equipment and machinery	38,034	39,947
Other equipment, plant and office equipment	2,286	2,743
Advance payments and construction in progress	2,273	2,955
	<b>53,955</b>	<b>58,708</b>

Property, plant and equipment decreased by EUR 4.8 billion to EUR 54.0 billion. Capital expenditure amounted to EUR 7.1 billion; depreciation and amortization increased to around EUR 9.5 billion; disposals amounted to EUR 3.4 billion and related mainly to the sale of real estate in the form of sale and lease back

transactions.

The development of property, plant and equipment for 2002 is shown in the table of consolidated noncurrent assets.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Leasing**

Minimum lease payments under leases expiring subsequent to December 31, 2002, are shown below (millions of EUR).

Year	Capital leases	Operating leases
2003	63	1,813
2004	58	1,609
2005	60	1,232
2006	58	924
2007	60	842
after 2007	666	3,630
<b>Total minimum lease payments</b>	<b>965</b>	<b>10,050</b>
Imputed interest	(422)	
<b>Present value of net minimum lease payments</b>	<b>543</b>	

Capital leases are primarily for office buildings and have terms of up to 25 years. EUR 794 million of the operating leases payments relate to real estate previously sold and leased back with average terms of 18 years.

**(14) Financial Assets**

The net carrying amounts of financial assets at:

	As of December 31,	
	2002	2001
	(millions of )	
Investments in unconsolidated subsidiaries	149	228
Loans to unconsolidated subsidiaries	58	82
Investments in associated companies	2,593	3,944
Other investments in related companies	1,021	1,895
Long-term loans to associated and related companies	3	395
Other investments in noncurrent securities	238	879
Other long-term loans	107	534
	<b>4,169</b>	<b>7,957</b>

The decrease of EUR 1,351 million in the net carrying amount of investments in associated companies relates mainly to the reclassification of the shares in Ben (EUR 543 million) and an investee of T-Mobile USA (EUR 283 million) as a result of their full consolidation for the first time in the year under review. Furthermore, the decrease is marked by current year losses and the amortization of goodwill, particularly relating to comdirect bank. These developments were offset by increases in various related companies of T-Mobile International AG



amounting to EUR 437 million.

The decrease of EUR 874 million in other investments in related companies is largely a consequence of the valuation adjustment on and the subsequent disposal of the shares held in France Telecom.

Long-term loans primarily include loans to associated and related companies. The decrease is mainly attributable to valuation adjustments for loans to cable companies.

Other investments in noncurrent securities mainly include fixed-interest securities. The decrease is attributable to the sale of part of the fixed-interest securities from the portfolio of Deutsche Telekom Holding B.V., Amsterdam, and a valuation adjustment in Deutsche Telekom AG's securities portfolio.

A considerable proportion of other long-term loans was reclassified as loans to unconsolidated subsidiaries in the year 2002 as a result of the acquisition of HoldCo/ Polpager by T-Mobile International AG. Furthermore, the decrease in other long-term loans was also attributable to the repayment of a Deutsche Telekom AG loan by Deutsche Post.

**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The development of financial assets is shown in the table of noncurrent assets.

Significant investments in associated companies are shown below:

Name	As of December 31, 2002			As of December 31, 2001		
	Deutsche Telekom share	Net carrying amount	of which: Embedded goodwill <sup>(1)</sup>	Deutsche Telekom share	Net carrying amount	of which: Embedded goodwill <sup>(1)</sup>
	(%)	(millions of )		(%)	(millions of )	
PTC	49.0	1,287	1,122	45.0	1,232	1,114
GSM Facilities	25.6	586		24.0	516	
MTS <sup>(2)</sup>	36.2	455	11	36.2	435	16
Other		265	52		1,761	685
		<b>2,593</b>	<b>1,185</b>		<b>3,944</b>	<b>1,815</b>

(1) Net difference between carrying value and equity in net assets

(2) Proportional market value of EUR 1,277 million and EUR 1,459 million at December 31, 2002 and 2001 respectively

**(15) Inventories, Materials and Supplies**

	As of December 31,	
	2002	2001
	(millions of )	
Raw materials and supplies	466	597
Work in process	350	458
Finished goods and merchandise	730	606
Advance payments	10	10
	<b>1,556</b>	<b>1,671</b>

Inventories, materials and supplies decreased compared with the previous year by EUR 114 million or 6.8%. This figure includes offsetting effects of EUR 26 million resulting from changes in the composition of the Deutsche Telekom Group.

Raw materials and supplies include spare parts for data communications equipment, transmission equipment and other telecommunications spare parts, components and cable. Work in process is mainly related to projects which have not yet been completed, such as the installation of telecommunications systems and the implementation of IT systems solutions.

Finished goods and merchandise relate mainly to inventories of terminal equipment held both for resale and leasing as well as existing rights of use for submarine cables.

Advance payments relate primarily to orders for terminal equipment.

**(16) Receivables**

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	(millions of )	
Trade accounts receivable	5,840	6,173
Receivables from unconsolidated subsidiaries	171	423
Receivables from associated and related companies	247	230
	<b>6,258</b>	<b>6,826</b>

In December 2002, T-Systems International GmbH and its subsidiaries T-Systems PCM AG and T-Systems GEI GmbH sold without recourse certain trade accounts receivable amounting to EUR 276 million to a special purpose vehicle as part of an asset-backed securitization program. The contract explicitly rules out the retransfer of the receivables sold. Appropriate discounts have been agreed to cover financing and program costs and possible bad debt losses. The contract provides for a rebate of the discounts if the risks

**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

covered by the discounts are not utilized by the purchaser. Servicing of the receivables sold is performed by T-Systems on behalf of the purchaser.

Since December 2001, Deutsche Telekom AG has sold by way of global assignment certain trade accounts receivable to a special-purpose vehicle as part of an asset-backed securitization program. The contract explicitly rules out the retransfer of the receivables sold. The contract provides for a rebate of the discounts if the risks covered by the discounts are not utilized by the purchaser. Servicing of the receivables sold is performed by Deutsche Telekom on behalf of the purchaser.

All receivables are due within one year, with the exception of EUR 63 million for trade accounts receivables.

The allowance for doubtful accounts and changes therein are in millions of euros as follows:

Years	As of January 1	Charged to costs and expenses	Amounts written off/released	As of December 31
	(millions of )			
2000	493	379	(82)	790
2001	790	1,167	(623)	1,334
2002	1,334	701	(680)	1,355

The Company directly wrote off accounts receivable balances of EUR 414 million in 2002 (December 31, 2001: EUR 391 million; December 31, 2000: EUR 344 million).

**(17) Other Assets**

	As of December 31,	
	2002	2001
	(millions of )	
Tax receivables	1,782	3,287
Accrued interest	390	352
Receivables from employees	46	34
Receivables from reimbursements and loans receivable	96	221
Miscellaneous other assets	1,078	1,072
	<b>3,392</b>	<b>4,966</b>

The decrease in other assets relates mainly to the decrease in tax receivables, which consist mainly of income taxes. The considerable decrease in income tax receivables relates mainly to the non-recurrence of the reimbursement of corporate income tax resulting from the dividend payment of T-Mobile International AG to Deutsche Telekom AG amounting to EUR 1.1 billion in the previous year. Furthermore, a claim for reimbursement shown in the previous year has been realized. Receivables in the year under review include tax refunds of approximately EUR 0.8 billion relating to the recognition of amortization on Deutsche Telekom AG's goodwill.

**(18) Marketable Securities**

	<u>As of December 31,</u>	
	<u>2002</u>	<u>2001</u>
	<u>(millions of )</u>	
Treasury shares	7	7
Other marketable securities	406	695
	<u>413</u>	<u>702</u>

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The number of treasury shares at the balance sheet date, 2,670,828, unchanged from the December 31, 2001 is made up as follows:

	<b>Number of Shares</b>
1996 Employee Stock Purchase Plan	459,900
1999 Employee Stock Purchase Plan	5,185,278
Decrease as a result of the 2000 Employee Stock Purchase Plan	(2,988,980)
Shares acquired from the KfW, not yet issued	14,630
	<b>2,670,828</b>

The shares are recorded in the balance sheet at an acquisition cost of EUR 2.56 per share. The shares not purchased by employees in 2000 (14,630) were initially shown in the balance sheet at acquisition cost of EUR 0.9 million and written down to the lower market trading price applicable at the balance sheet date. The total proportion of treasury shares in capital stock is 0.07%.

The decrease in other marketable securities compared with the previous year is mainly attributable to the reduction of Deutsche Bundespost bonds and debentures held to maintain favorable trading conditions and the maturity of callable bonds.

Other marketable securities primarily relate to own bonds held to maintain favorable trading conditions (EUR 139 million) and callable step-up bonds (EUR 225 million) held by Deutsche Telekom AG.

**(19) Liquid Assets**

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	(millions of )	
Checks	10	47
Petty cash and deposits at the Bundesbank	42	25
Cash in banks (including deposits at Deutsche Postbank AG)	1,853	2,796
	<b>1,905</b>	<b>2,868</b>

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	(millions of )	
Cash and cash equivalents		
Original maturity less than 3 months	1,712	2,738
	193	130

Temporary cash investments (original maturity longer than 3 months)

1,905	2,868
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Cash and cash equivalents with original maturity of less than 3 months consist primarily of fixed-term bank deposits, checking account balances, deposits at the Bundesbank and Deutsche Postbank AG and petty cash. Temporary cash investments consist almost exclusively of fixed-term bank deposits.

The development of cash and cash equivalents is shown in the consolidated statement of cash flows.

**(20) Prepaid Expenses and Deferred Charges**

Prepaid expenses and deferred charges of EUR 771 million (Dec. 31, 2001: EUR 813 million) include discounts on loans of EUR 295 million (Dec. 31, 2001: EUR 351 million) which are amortized on a straight line basis over the terms of the respective liabilities. Other prepaid expenses and deferred charges are also shown for advance personnel costs and lease payments.

**(21) Shareholders Equity**

A detailed account of the development of the consolidated shareholders' equity for the years 2000, 2001 and 2002 is presented in a separate table before the notes to the consolidated financial statements.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The development of the consolidated shareholders' equity from December 31, 1995, to December 31, 2002, is as follows (millions of €):

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\* unaudited

**(22) Capital Stock**

In accordance with Article 5 (1) of the Articles of Incorporation, Deutsche Telekom AG's capital stock totaled EUR 10,746 million at December 31, 2002, representing 4,197.8 million registered ordinary no par value shares. Each share entitles the holder to one vote.

The Federal Republic's direct shareholding in Deutsche Telekom AG, represented by the Federal Agency, was 30.75% at December 31, 2002; the KfW's shareholding was 12.02% at December 31, 2002. Correspondingly, the Federal Republic held 1,291 million no-par value shares (EUR 3,304 million) of the capital stock as at December 31, 2002, while the KfW held 505 million no-par value shares (EUR 1,292 million). The remaining shares are in free float.

In the course of the acquisition of T-Mobile USA/Powertel, Deutsche Telekom AG granted options on Deutsche Telekom shares in exchange for the warrants in circulation between Deutsche Telekom and T-Mobile USA/Powertel at the time of the acquisition. At December 31, 2002, the number of Deutsche Telekom shares deposited as collateral for the outstanding options granted to T-Mobile USA/Powertel employees amounted to 26,769,950.

**Authorized Capital**

With the approval of the Supervisory Board, the Board of Management is authorized to increase the capital stock (share capital) by up to a nominal amount of EUR 3,865,093,163.52 by issuing up to 1,509,802,017 ordinary registered shares for non-cash contributions in the period up to May 25, 2005. The authorization may be exercised in full or in part. The preemptive right of shareholders is precluded. The Board of Management is authorized to determine the rights accruing to the shares in the future and the conditions for issuing shares with the approval of the Supervisory Board. As of December 31, 2002 1,168,148,391 of the 1,509,802,017 ordinary shares have been issued for the acquisition of T-Mobile USA and Powertel.

**Contingent Capital**

The capital stock may be conditionally increased by up to EUR 500,000,000, divided into up to 195,312,500 shares (Contingent Capital I). The contingent capital may be increased only to the extent that

- a. the holders or creditors of conversion rights or warrants attached to the convertible bonds or bonds with warrants issued by May 28, 2006 by Deutsche Telekom AG or a company in which it has a direct or indirect majority holding on the basis of the authorization granted by resolution of the Shareholders Meeting of May 29, 2001, exercise their conversion or option rights or
- b. holders or creditors obligated to convert the convertible bonds issued by May 28, 2006, by Deutsche Telekom AG or companies in which it has a direct or indirect majority holding pursuant to the authorization granted by resolution of the Shareholders Meeting of May 29, 2001, fulfill their conversion obligation.



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The new shares are expected to participate in profits starting at the beginning of the financial year in which they are issued as the result of the exercise of any conversion or option rights being exercised or the fulfillment of any conversion obligations. The Contingent Capital I was used in 2003 through the issuance of approximately EUR 2.3 billion of convertible bonds that are mandatorily convertible into common shares of Deutsche Telekom AG at maturity on June 1, 2006. The convertible bonds were issued by Deutsche Telekom's Dutch finance subsidiary, Deutsche Telekom International Finance B.V., and guaranteed by Deutsche Telekom AG. The Securities were priced at par with a 6.5% coupon and a conversion ratio that, depending on the share price performance, may vary from a ratio of 3,417.1679 shares to 4,237.2881 shares for each bond (EUR 50,000 nominal amount). The Securities were placed with non-U.S. institutional investors outside the United States.

Pursuant to the authorization granted by resolution of the Shareholders' Meeting of May 29, 2001 the share capital was conditionally increased by up to EUR 307,200,000, divided into up to 120,000,000 new individual no par value registered shares (Contingent Capital II). The contingent capital increase was made exclusively for the purpose of granting subscription rights to members of the Board of Management of Deutsche Telekom AG, executives at levels below the Board of Management of Deutsche Telekom AG and other executives, managers and specialists of Deutsche Telekom AG and to Board of Management members, managing board members and other executives of second- and lower-tier domestic and foreign Group companies on the basis of a 2001 Stock Option Plan. As of December 31, 2002 none of the subscription rights granted under the Stock Option Plan 2001 have been exercised.

Pursuant to the authorization granted by resolution of the Shareholders' Meeting of May 29, 2001 the share capital was conditionally increased by up to EUR 2,621,237.76, divided into up to 1,023,921 shares (Contingent Capital III). The contingent capital increase serves exclusively to grant subscription rights to members of the Board of Management and executives of the Corporation, as well as Board of Management members, managing board members and other executives of second- and lower-tier affiliated companies on the basis of a Stock Option Plan as provided for in the resolution of the Shareholders' Meeting of May 25, 2000. As of December 31, 2002 none of the subscription rights granted under the Stock Option Plan 2000 have been exercised.

**Treasury Shares**

Pursuant to the authorization granted by resolution of the Shareholders' Meeting of May 28, 2002 the Board of Management's authorization to acquire treasury shares, which was resolved by the shareholders' meeting on May 29, 2001, was rescinded. At the same time, Deutsche Telekom AG was authorized to acquire treasury shares up to a maximum of 10% of the share capital, i.e., a total of no more than 419,775,242 shares. These treasury shares may be used for listings on foreign stock exchanges, offered as compensation in mergers or the acquisition of companies and equity interests, or retired. The authorization may be exercised in full or in part, and is valid until November 18, 2003.

**(23) Additional Paid-In Capital**

The additional paid-in capital of the consolidated Group exceeds the additional paid-in capital of Deutsche Telekom AG of EUR 24,319 million by EUR 25,758 million. This is due in part to the recording in 2001 of the new Deutsche Telekom shares issued in the course of the acquisition of T-Mobile USA/Powertel at their market value (EUR 28,680 million) instead of their nominal value (EUR 2,990 million), which is permitted in the consolidated financial statements. Furthermore, there were other allocations to additional paid-in capital in 2002 amounting to EUR 68 million from the exercise of conversion options by former shareholders of T-Mobile USA/Powertel. The shares in Deutsche Telekom reserved for these conversion options in a trust were included in the unconsolidated financial statements of Deutsche Telekom AG in 2001 at the time of the appropriation of the additional paid-in capital.

**(24) Retained Earnings**

In addition to the transfers made from Deutsche Telekom AG's net income from prior years, retained earnings include the consolidated group's share of the consolidated subsidiaries' net income or losses, provided they were generated by such subsidiaries since being included in the consolidated Group, as well as a reserve for

treasury shares held by the Company in accordance with § 272 (4) HGB. This item also includes the cumulative effects of consolidation entries from prior years.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(25) Minority Interest**

Minority interest represents the minority shareholders' proportionate share of the equity of the consolidated subsidiaries and relates primarily to T-Online International AG, Croatian Telecom, MATAV, Slovenske and RadioMobil.

**(26) Stock-Based Compensation**

**Deutsche Telekom AG**

2000 Stock Option Plan

In the 2000 financial year, Deutsche Telekom granted stock options to certain employees for the first time. On July 19, 2000, Deutsche Telekom granted 1,023,920.54 options for the purchase of 1,023,920.54 shares at an exercise price of EUR 62.69 to the beneficiaries of the 2000 Stock Option Plan on the basis of the resolution passed by the shareholders' meeting in May 2000. The quoted fair market value of Deutsche Telekom's common stock as quoted on Frankfurt am Main Xetra on the grant date was EUR 60.40 per share. The term of the options runs until July 20, 2005.

The options could not be exercised before the end of the lock-up period on July 19, 2002, and may only be exercised if and when the absolute and relative performance targets have both been exceeded at least once in the period from July 20, 2002, to July 19, 2005.

The absolute performance target is considered to have been reached when the moving average of the closing price of the shares in Xetra trading on the Frankfurt Stock Exchange exceeds the exercise price by more than 20% for a period longer than 30 days.

The relative performance target is linked to share price performance relative to the performance of the Dow Jones Euro Stoxx 50® Total Return Index. The options may only be exercised if, after the end of the two-year lock-up period, the share price performance adjusted for dividends, options and other special rights (total shareholder return) exceeds the performance of the Euro Stoxx 50® Total Return index measured on a moving thirty-day average basis.

Deutsche Telekom reserved the right, at its election, to settle the options through the payment of a cash amount (stock appreciation rights - SAR) instead of issuing new shares. The exercise of an SAR cancels the related option and the exercise of an option cancels the related SAR. As at December 31, 2002, no resolution on conversion had been passed to this effect.

As of December 31, 2002, the weighted average remaining time to maturity of the outstanding options from the 2000 Stock Option Plan was approximately 2.5 years.

The shareholders' meeting in May 2001 resolved that no further stock options would be granted on the basis of the 2000 Stock Option Plan.

The activities relating to the stock options granted by Deutsche Telekom AG to beneficiaries of the 2000 Stock Option Plan (options in thousands) are as follows:

<b>2000 Stock Option Plan</b>		
<b>2002</b>	<b>2001</b>	<b>2000</b>

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	Stock options	Weighted- average exercise price	Stock options	Weighted- average exercise price	Stock options	Weighted- average exercise price
	(in thousands)	( )	(in thousands)	( )	(in thousands)	( )
Outstanding at beginning of year	1,001	62.69	1,022	62.69		
Granted					1,024	62.69
Exercised						
Forfeited	7	62.69	21	62.69	2	62.69
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
Outstanding at end of year	994	62.69	1,001	62.69	1,022	62.69
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
Exercisable at end of year	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*2001 Stock Option Plan*

For the 2001 Stock Option Plan, the shareholders' meeting in May 2001 resolved to increase the capital stock (share capital) of Deutsche Telekom AG by EUR 307,200,000 by issuing up to 120,000,000 new no-par value registered shares. This contingent capital increase is exclusively for the purpose of allowing up to 120,000,000 options to be issued to members of the Board of Management and other executives of the Company and lower-tier affiliated companies as part of the Deutsche Telekom 2001 Stock Option Plan.

50% of the options granted to each beneficiary may only be exercised following the end of a lock-up period of two years, starting from the day on which the options are granted. The remaining 50% of the options granted to each beneficiary may be exercised at the earliest following the end of a lock-up period of three years, starting from the day on which the options are granted.

The exercise price is payable upon exercise of the options. The exercise price per share is 120% of the reference price. The reference price corresponds to the non-weighted average of the closing price of the Deutsche Telekom shares in Xetra trading (or a comparable successor system) as operated by Deutsche Boerse AG on the Frankfurt Stock Exchange over the last 30 trading days before the day on which the options are granted. If the average price calculated using this method is lower than the closing price of the Deutsche Telekom shares in Xetra trading (or a comparable successor system) as operated by Deutsche Boerse AG on the Frankfurt Stock Exchange on the day on which the options are granted, this closing price shall be taken as the reference price. The exercise price may not be lower than the notional value of one share in the capital stock (share capital). The exercise price is also the performance target.

The options may not legally be sold, transferred, pledged or otherwise disposed of except in the event of death, in which case the options are transferred to the heirs.

Deutsche Telekom reserved the right, at its election, to settle the options through the payment of a cash amount (stock appreciation rights - SAR) instead of issuing new shares. The exercise of an SAR cancels the related option and the exercise of an option cancels the related SAR. As at December 31, 2002, no resolution on conversion had been passed to this effect.

On August 13, 2001, Deutsche Telekom granted 8,220,803 options for the purchase of 8,220,803 shares at an exercise price of EUR 30.00 to the beneficiaries of the 2001 Stock Option Plan on the basis of the resolution passed by the shareholders' meeting in May 2001. The quoted fair market value of Deutsche Telekom's common stock as quoted on Frankfurt am Main Xetra on the grant date was EUR 19.10 per share. The term of the options runs until August 12, 2011.

In 2002, Deutsche Telekom granted additional stock options to certain employees. On July 15, 2002, Deutsche Telekom granted a further 3,927,845 options for the purchase of 3,927,845 shares at an exercise price of EUR 12.36 to the beneficiaries of the Stock Option Plan on the basis of the resolution passed by the shareholders' meeting in May 2001. The quoted fair market value of Deutsche Telekom's common stock as quoted on Frankfurt am Main Xetra on the grant date was EUR 10.30 per share. The term of the options runs until July 14, 2012.

As of December 31, 2002, the weighted average remaining time to maturity of the outstanding options from the 2001 Stock Option Plan was approximately 8.8 years.

The activities relating to the stock options granted by Deutsche Telekom to beneficiaries of the 2001 Stock Option Plan (options in thousands) are as follows:

**2001 Stock Option Plan**

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	2002		2001	
	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price
	in thousands	( )	in thousands	( )
Outstanding at beginning of year	8,219	30.00	8,221	30.00
Granted	3,928	12.36		
Exercised				
Forfeited	183	29.16	2	
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Outstanding at end of year	11,964	24.22	8,219	30.00
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Exercisable at end of year	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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Furthermore, in 2002, Deutsche Telekom AG granted 2,580 SARs to employees in countries in which it was not legally possible to grant stock options. As of December 31, 2002, 168,050 of the SARs granted were still outstanding.

**T-Online International AG***2000 Stock Option Plan*

In 2000, T-Online, for the first time, granted stock options to certain employees of T-Online International AG. On July 6, 2000, T-Online used its authority under shareholders' resolutions adopted in March 2000 to grant 214,473 options in respect of 214,473 shares of its stock to participants in its Stock Option Plan at an exercise price of EUR 37.65. The term of the options runs until July 6, 2005. In accordance with the decision of the shareholders' meeting, a total of 20,000,000 shares were reserved as contingent capital for future issuance under the 2000 Stock Option Plan. This contingent capital increase was reduced to EUR 214,473 at the shareholders' meeting on May 30, 2001.

No options granted under the 2000 Stock Option plan have yet been exercised, firstly because they were not exercisable until the end of the lock-up period on July 6, 2002 and, secondly, because the options are only exercisable when both the absolute and the relative performance targets have been exceeded at least once in the period between July 7, 2002, and July 6, 2005. The absolute performance target is deemed achieved when the moving thirty-day average closing Frankfurt Xetra share price exceeds the exercise price by more than 40%. The relative performance target is linked to the performance of the shares relative to the performance of the Dow Jones Euro Stoxx Telecom© index. The options may only be exercised if, following expiration of the two year lock-up period, the performance of the shares, adjusted for dividends, options and other special rights (total shareholder return), exceed the performance of the Euro Stoxx Telecom© index by more than 20% measured on a moving thirty-day average basis.

The weighted average remaining contractual life as of December 31, 2002, was 2.5 years.

The activities relating to the share options granted by T-Online International AG as part of the 2000 Stock Option Plan (in thousands) are as follows:

**2000 Stock Option Plan**

	2002		2001		2000	
	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price
	in thousands	( )	in thousands	( )	in thousands	( )
Outstanding at beginning of year	117	37.65	177	37.65	n/a	n/a
Granted					214	37.65
Exercised						
Forfeited	5	37.65	60	37.65	37	37.65
	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>
Outstanding at end of year	112	37.65	117	37.65	177	37.65
	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>
Exercisable at end of year	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>	<u>    </u>

*2001 Stock Option Plan*

The shareholders meeting on May 30, 2001, conditionally increased the capital stock of T-Online International AG by EUR 51,000,000 for the 2001 Stock Option Plan and authorized the Supervisory Board to issue preemptive rights to the members of the Board of Management of T-Online International AG and authorized the Board of Management to issue preemptive rights to managers below the Board of Management. These include directors, senior managers, selected specialists at T-Online International AG and members of the Boards of Management, members of the management and other directors, senior managers and selected specialists at Group companies within and outside Germany in which T-Online International AG directly or indirectly holds a majority shareholding.

The Stock Option Plan is structured as a premium priced plan . The exercise price is payable upon exercise of the options. The exercise price per share is 125% of the reference price. The reference price corresponds to the non-weighted average of the closing prices of the T-Online share in Xetra trading on the

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Deutsche Boerse AG stock exchange in Frankfurt am Main (or a subsequent system in place of the Xetra system) over the last 30 trading days before granting of the options. If the average closing price calculated by this method is lower than the closing price of the T-Share in Xetra trading on the Deutsche Boerse AG stock exchange (or a subsequent system) on the day of granting of the options, this closing price shall be taken as the reference price.

Options are granted in annual tranches for periods of five years; stock options can be granted for the last time in 2005.

50% of the options granted may only be exercised after a period of two years calculated from the day the options are granted. The remaining 50% of the options granted may only be exercised three years after the day the preemptive rights are issued. The options have a life of ten years from the date of granting, meaning that options granted in the first tranche in 2001 and the options granted in the second tranche in 2002 are forfeited without replacement of compensation at the latest on August 12, 2011, and July 14, 2012, respectively. As at December 31, 2002, the weighted average remaining time to maturity of the outstanding options from the 2001 Stock Option Plan was around 9 years.

2,369,655 options were granted on August 13, 2001, in the first tranche on the basis of the resolution passed by the shareholders meeting passed in May 2001. A further 2,067,460 options were granted in the second tranche on July 15 2002. The exercise price, the performance target, for the first tranche is EUR 10.35 (125% of the reference price of EUR 8.28) and for the second tranche EUR 10.26 (125% of the reference price of EUR 8.21).

The activities relating to the share options granted by T-Online International AG as part of the 2001 Stock Option Plan (in thousands) are as follows:

	<b>2001 Stock Option Plan</b>			
	<b>2002</b>		<b>2001</b>	
	<b>Stock options</b>	<b>Weighted-average exercise price</b>	<b>Stock options</b>	<b>Weighted-average exercise price</b>
	(in thousands)	( )	(in thousands)	( )
Outstanding at beginning of the year under review	2,348	10.35		
Granted	2,067	10.26	2,369	10.35
Exercised				
Forfeited			21	10.35
	_____	_____	_____	_____
Outstanding at end of year	4,415	10.31	2,348	10.35
	_____	_____	_____	_____
Exercisable at end of year	_____	_____	_____	_____

*Stock Option Plan for the Acquisition of Ya.com Shares*

In connection with the acquisition of shares in Ya.com, employees of Ya.com were granted 1,863,886 options for T-Online shares, for which the capital stock of T-Online was increased by EUR 1,863,886 in accordance with a resolution passed on September 22, 2000.



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The activities relating to the share options (in thousands) granted by T-Online International AG as part of the acquisition of shares are as follows:

**Ya.com 2000 Option Plan**

	2002		2001		2000	
	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price
	(in thousands)	( )	(in thousands)	( )	(in thousands)	( )
Outstanding at beginning of year	1,084	0.00	1,864	0.00	n/a	n/a
Granted					1,864	0.00
Exercised	376		692			
Forfeited	342		88			
Outstanding at end of year	366	0.00	1,084	0.00	1,864	0.00
Exercisable at end of year	366	0.00	1,084	0.00	280	0.00

In its function as conversion trustee, Dresdner Bank holds 430,000 options which may be sold under certain circumstances upon instruction by T-Online International AG. As the issuance of shares underlying these options for cash is viewed as an indirect cash payment by Ya.com shareholders to T-Online International AG as a result of the issue of T-Online shares, the proceeds of the sale of these options will be allocated upon sale as a premium to additional paid-in capital.

**T-Mobile USA**

Before its acquisition on May 31, 2001, T-Mobile USA had granted stock options to its employees. On May 31, 2001, as a consequence of the acquisition, all unvested, outstanding options of T-Mobile USA employees were converted from T-Mobile USA options into Deutsche Telekom options at a conversion rate of 3.7647 per unvested, outstanding T-Mobile USA option. The Deutsche Telekom shares linked to these options are administered in a trust deposit account that has been set up for the benefit of holders of T-Mobile USA stock options. The exercise price for each share of Deutsche Telekom AG common stock corresponds to the applicable exercise price per share of T-Mobile USA common stock divided by 3.7647. Furthermore, no more options will be granted under any other T-Mobile USA stock option plans.

At December 31, 2002, 25.0 million shares were available for outstanding options for the 1999 Management Incentive Stock Option Plan ( MISOP ), which was changed as a consequence of the acquisition on May 31, 2001. The MISOP provides for the issue of up to 8 million shares of Deutsche Telekom common stock, either as non-qualified stock options or as incentive stock options, plus the number of shares of common stock deliverable upon the exercise of the T-Mobile USA rollover options in accordance with the Agreement and Plan of Merger between Deutsche Telekom and T-Mobile USA. The vesting period and option term relating to the option plan are determined by the MISOP administrator. The options typically vest over a period of four years and have a term of up to 10 years.

**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The activities relating to the share options granted since the acquisition of T-Mobile USA are as follows:

	Year ended December 31, 2002		Seven months ended December 31, 2001	
	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price
	in thousands	(USD)	in thousands	(USD)
Outstanding, beginning of period	22,090	16.21	6,444	58.27
Conversion of historical T-Mobile USA options			(6,444)	58.27
Adjustment for T-Mobile merger			24,278	15.36
Granted	5,964	13.35		
Exercised	2,133	3.35	1,639	3.21
Forfeited	941	19.51	549	17.47
Outstanding at end of year	24,980	16.41	22,090	16.21
Exercisable at end of year	10,028	13.95	6,299	9.88

Ranges of the exercise prices in USD	Outstanding options			Exercisable options	
	Number (in thousands)	Weighted-average remaining contractual life (years)	Weighted-average exercise price (USD)	Number (in thousands)	Weighted-average exercise price (USD)
0.00 - 7.60	5,631	5.1	2.68	4,460	2.56
7.61 - 15.20	8,351	8.0	11.98	1,359	8.75
15.21 - 22.80	73	6.5	17.62	53	17.62
22.81 - 30.39	9,504	7.5	26.25	3,447	27.17
30.40 - 37.99	1,421	7.1	30.98	709	30.98
0.00 - 37.99	24,980	7.1	16.41	10,028	13.95

**Powertel**

Before its acquisition on May 31, 2001, Powertel had granted stock options to its employees. On May 31, 2001, as a consequence of the acquisition, all unvested, outstanding Powertel options were converted into Deutsche Telekom AG options at a conversion rate of 2.6353. The Deutsche Telekom AG shares linked to these options are administered in a trust deposit account set up for the benefit of holders of Powertel stock options. The exercise price for each share of Deutsche Telekom AG common stock corresponds to the applicable exercise price per share of Powertel common stock divided by 2.6353. Furthermore, no more options will be granted under any other Powertel stock option plans.

The Powertel 2000 Stock Plan had 535,306 shares available at December 31, 2002. This plan was changed as a consequence of the acquisition. Under the terms of this plan, all employees, managers, directors, consultants and advisors may be eligible for the allocation of options, conditional share allocations or other allocations

within the framework of the 2000 Stock Plan.

A total of 1,254,695 Deutsche Telekom shares were available for outstanding options at December 31, 2002, for the Powertel Employee Stock Option Plan in force since 1991 ( 1991 Option Plan ). The Powertel Board of Directors has decided not to grant any further options in the 1991 Option Plan.

At December 31, 2002, there were no shares available for outstanding options for the Non-employee Stock Option Plan ( Non-employee Plan ). The Powertel Board of Directors has decided not to grant any further options in the Non-employee Plan.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The activities relating to the share options granted since the acquisition of Powertel are as follows:

	Year ended December 31, 2002		Seven Months ended December 31, 2001	
	Stock options	Weighted-average exercise price	Stock options	Weighted-average exercise price
	in thousands	(USD)	in thousands	(USD)
Outstanding, beginning of period	2,509	19.50	2,010	53.31
Conversion of historical Powertel options			(2,010)	53.31
Adjustment for T-Mobile merger			5,323	20.04
Granted				
Exercised	446	5.39	1,200	6.29
Forfeited	273	27.27	1,614	31.42
Outstanding at end of year	1,790	21.85	2,509	19.50
Exercisable at end of year	891	16.93	883	8.76

Ranges of the exercise prices in USD	Outstanding options			Exercisable options	
	Number (in thousands)	Weighted-average remaining contractual life (years)	Weighted-average exercise price (USD)	Number (in thousands)	Weighted-average exercise price (USD)
	0.02 - 7.60	543	5.2	5.58	433
7.61 - 15.20	142	5.4	9.90	121	9.64
15.21 - 22.80	22	6.8	19.78	14	19.61
22.81 - 30.39	512	8.0	26.86	50	26.46
30.40 - 38.00	571	7.2	35.87	273	36.18
0.02 - 38.00	1,790	6.7	21.85	891	16.93

**MATAV**

On April 26, 2002, the annual Shareholders Meeting of Magyar Tavkozlesli Reszvenytarsasag (MATAV) approved the introduction of a new management share option plan.

In order to satisfy the exercise of options granted, the annual Shareholders Meeting of MATAV authorized MATAV's Board of Directors to purchase 17 million A series registered ordinary shares, each having a nominal value of HUF 100 as treasury shares.

On July 1, 2002, MATAV used its authority under the shareholders resolutions adopted in April 2002 to grant 3,964,600 options in respect of 3,964,600 shares of its stock to participants in its stock option plan at an exercise price of HUF 933 for the First Tranche (exercisable 2003) and HUF 950 for the Second Tranche and Third Tranche (exercisable 2004 and 2005, respectively). The quoted fair market value of MATAV common

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stock as quoted on BET (Budapest Stock Exchange) on the grant date was HUF 833 per share. The options expire five years from the date of grant (June 30, 2007.) The remaining contractual life as of December 31, 2002, was 4.5 years.

The options with respect to the maximum of one-third of the shares that can be purchased under the relevant options (first tranche) may be exercised at any time from and including the first anniversary of the grant date of such options until the end of the term.

The options with respect to the maximum of a further one-third of the shares that can be purchased under the relevant options (second tranche) may be exercised at any time from and including the second anniversary of the grant date of such options until the end of the term.

The options with respect to the rest of the shares that can be purchased under the options (third tranche) may be exercised at any time from and including the third anniversary of the grant date of such options until the end of the term.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The options may not be sold, transferred, assigned, charged, pledged or otherwise encumbered or disposed of to any third person.

The activities relating to the share options granted by MATAV are as follows:

	<b>2002 Stock Option Plan</b>	
	<b>Stock options</b>	<b>Weighted-average exercise price</b>
	<b>(in thousands)</b>	<b>(HUF)</b>
Outstanding, beginning of period		
Granted	3,965	944
Exercised		
Forfeited		
	—	—
Outstanding at end of year	3,965	944
	—	—
Exercisable at end of year	—	—

**(27) Accruals for Pensions and Similar Obligations**

Deutsche Telekom's pension obligations for non-civil servants are provided for by a range of defined benefit plans; there are further obligations under Article 131 of the Basic Law (Grundgesetz - GG). Deutsche Telekom's indirect pension obligations were made to its employees via the Versorgungsanstalt der Deutschen Bundespost (VAP) and the Deutsche Telekom Betriebsrenten-Service e.V. (DTBS).

The VAP provides pension services for pensioners who were employed by Deutsche Telekom. The VAP benefits, which supplement statutory pension benefits up to the level specified by the pension benefits formula, are generally calculated on the basis of employees' compensation during specific periods of their employment. Within the scope of negotiations on the realignment of the company pension plan, the employer and the trade unions agreed in 1997 on arrangements for the protection of vested VAP benefits. Pursuant to this agreement, the benefit obligations due to retirees and employees then approaching retirement remained unchanged. For younger employees, the obligations were converted into an initial amount based on the number of years of coverage to date, which was then credited to a capital account held by the employer (cash balance plan). Deutsche Telekom annually credits further amounts to this account; when the insured event occurs, the account balance is paid out in full, in installments or converted into a pension. If the relevant employees had not reached the age of 35 and had been insured for less than ten years, their benefit obligations became due directly from Deutsche Telekom. The DTBS was founded for processing the remaining obligations.

A new regulation of VAP benefits was made by collective agreement in the year 2000 without affecting the Company's obligations. Since November 2000 Deutsche Telekom has assumed the direct obligation to provide payments to pensioners covered by this collective agreement. The VAP's obligations are therefore suspended (parallel obligation). The VAP provides the pension services for and on behalf of Deutsche Telekom. Pension accruals are recorded in the balance sheet for financial reporting purposes for the direct pension obligations in accordance with U.S. GAAP (SFAS No. 87). Due to the direct nature of the parallel obligation, these pension accruals must also be shown in the balance sheet for tax reporting purposes in accordance with § 6a of the German Income Tax Act (EStG). Those pensioners remaining in the VAP continue to receive their benefits directly from the VAP as the provider of pension services.

Benefits relating to other direct pension plans are generally determined on the basis of salary levels and years of service; these benefit obligations are also usually determined by the amounts credited by Deutsche



Telekom to its capital accounts.

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table shows the composition of pension obligations:

	As of December 31,	
	2002	2001
	(millions of )	
Pension obligations:		
Direct	2,927	2,683
Indirect	1,007	966
Obligations in accordance with Article 131 GG	8	12
	<b>3,942</b>	<b>3,661</b>

The obligation amounts shown contain a so-called additional minimum liability for certain pension plans. An additional minimum liability is a step-up amount for pension obligations relating to certain pension plans, whose changes are shown under German GAAP as affecting net income (loss), but are reflected as a charge to equity under U.S. GAAP. Excluding the additional minimum liability, the accrual for pensions amounts to EUR 3,465 million (2001: EUR 3,402 million).

	As of December 31,	
	2002	2001
	(millions of )	
Actuarial present value of benefits:		
Vested	3,978	3,701
Nonvested	409	342
<b>Accumulated benefit obligation</b>	<b>4,387</b>	<b>4,043</b>
Effect of projected future salary increases	85	121
<b>Projected benefit obligation</b>	<b>4,472</b>	<b>4,164</b>
Plan assets at fair value	(412)	(405)
<b>Projected benefit obligation in excess of plan assets</b>	<b>4,060</b>	<b>3,759</b>
Unrecognized net (losses)	(595)	(357)
<b>Unfunded accrued pension cost</b>	<b>3,465</b>	<b>3,402</b>
<b>Additional minimum liability</b>	<b>477</b>	<b>259</b>
<b>Total obligation</b>	<b>3,942</b>	<b>3,661</b>

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Taking into consideration the plan assets, the total pension obligations are fully disclosed.

The corresponding pension accruals measured in accordance with § 6a of the German Income Tax Act (Einkommensteuergesetz - EStG) are EUR 3,474 million (December 31, 2001: EUR 2,995 million).

The amount of pension obligations was determined using actuarial principles that are consistent with U.S. GAAP (SFAS No. 87) and using the assumptions at the respective balance sheet dates as shown in the following table:

	2002	2001	2000
Discount rate	5.75%	6.00%	6.25%
Projected salary increase	2.75%-3.50%	2.75%-3.50%	2.75%-3.50%
Expected return on assets	6.00%	6.00%	6.00%-6.50%
Projected pension increase	1.50%	1.50%	1.50%

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Development of the projected benefit obligation:

	2002	2001
	(millions of )	
<b>Projected benefit obligation, beginning of year</b>	<b>4,164</b>	<b>3,764</b>
Service cost	155	144
Interest cost	241	228
Change in obligations	(59)	(6)
Actuarial losses	201	280
Total benefits actually paid	(230)	(246)
<b>Projected benefit obligation, end of year</b>	<b>4,472</b>	<b>4,164</b>

Development of plan assets at fair value:

	2002	2001
	(millions of )	
<b>Plan assets at fair value, beginning of year</b>	<b>405</b>	<b>379</b>
Actual return on plan assets	(20)	2
Contributions by employer	79	73
Benefits actually paid through pension funds	(52)	(49)
<b>Plan assets at fair value, end of year</b>	<b>412</b>	<b>405</b>

Net periodic pension cost is summarized as follows:

	2002	2001	2000
	(millions of )		
Service cost	155	144	119
Interest cost	241	228	208
Return on Plan Assets	(24)	(24)	(17)
Amortization of gains and losses	7	0	
<b>Net periodic pension cost</b>	<b>379</b>	<b>348</b>	<b>310</b>

**Civil servant retirement arrangements**

Until the 2000 financial year, Deutsche Telekom AG maintained a special pension fund (Unterstützungskasse) for its active and former civil servants, which was merged with the special pension funds of Deutsche Post AG and Deutsche Postbank AG by notarized agreement on December 7, 2000, to form the joint pension fund Bundes-Pensions-Service fuer Post und Telekommunikation e.V. (BPS-PT). On January 11, 2001, the fund was entered in the Register of Associations with retroactive effect from July 1, 2000. The BPS-PT works for all three companies of all three companies and also handles financial administration for the Federal Republic on a trust basis. It carries out all transactions for civil servants' pension and allowance

payments for Deutsche Post AG, Deutsche Postbank AG and Deutsche Telekom AG.

In accordance with the provisions of the Posts and Telecommunications Reorganization Act (Postneuordnungsgesetz – PTNeuOG), BPS-PT makes pension and allowance payments to retired civil servant employees and their surviving dependents who are entitled to pension payments as a result of civil servant status. The level of Deutsche Telekom AG’s payment obligations to its special pension fund is defined under § 16 of the Law concerning the Legal Provisions for the Former Deutsche Bundespost Staff (PostPersRG). Since 2000, Deutsche Telekom AG has been legally obligated to make annual contributions to the special pension fund amounting to 33% of the pensionable gross remuneration of active civil servants and the notional pensionable gross remuneration of civil servants on leave of absence. The funding of this annual contribution is recognized as a period expense. These contributions amounted to EUR 838 million, EUR 845 million and EUR 895 million in 2002, 2001 and 2000, respectively (see note (33) – Guarantees and Commitments, and Other Financial Obligations).

Under PTNeuOG, the Federal Republic compensates the special pension fund for any shortfalls between the ongoing payment obligations of the special pension fund, amounts received from Deutsche Telekom AG and returns on assets, and guarantees that the special pension fund has sufficient monies to satisfy the

**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

obligations it has assumed. The Federal Republic cannot require reimbursement from Deutsche Telekom AG for amounts paid by it to the special fund.

**(28) Other accruals**

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>(millions of )</b>	
Taxes	2,086	1,938
Provisions for deferred taxes	1,646	5,348
Accruals other than taxes		
Employee benefits		
Civil Service Health Insurance Fund	1,101	1,079
Personnel restructuring	558	252
Other obligations	1,080	916
	<b>2,739</b>	<b>2,247</b>
Outstanding invoices	2,540	2,218
Unused telephone units on phone cards sold	500	422
Loss contingencies	426	514
Advertising cost subsidies / commissions	351	270
Restoration commitments	303	265
Risks related to real estate	227	168
Refunds to be granted	168	132
Litigation risks	164	266
Investment risks	126	145
Deferred maintenance	55	56
Other	824	777
	<b>8,423</b>	<b>7,480</b>
	<b>12,155</b>	<b>14,766</b>

Due to differences between the book value and the fair market value of mobile communications licenses, intangible assets were recorded in 2001 upon first consolidation of T-Mobile USA with the accounting of the purchase price. This generated a provision for deferred taxes of EUR 5,812 million which was reduced to EUR 2,167 million in 2002 after write-downs on mobile communications licenses.

The increase in other accruals (excluding deferred taxes) is mainly attributable to an increase in personnel accruals (EUR 492 million) and accruals for outstanding invoices (EUR 322 million).

The Civil Service Health Insurance Fund (PBeaKK) provides services for its members mainly in cases of illness, birth or death and calculates the allowances. When Postreform II came into effect, the PBeaKK was closed to new members. Due to the aging of the group of people insured, there is an expected shortfall between the fund's sources of regular income and benefits paid. Deutsche Telekom AG has accrued the actuarially determined present value of this future deficit which Deutsche Telekom has to cover, taking the 1998 life expectancy tables by Prof. Dr. Klaus Heubeck ( Richttafeln 1998 ) into account, which primarily reflect the increase in average life expectancy. The expense for the addition to this accrual was EUR 44 million in the year under review (2001: EUR 70 million; 2000: EUR 142 million).

Deutsche Telekom had, in response to competition, announced its intention to reduce its workforce by approximately 60,000 to 170,000 full-time equivalent employees by the end of the year 2000 (excluding employees of subsidiaries first consolidated after January 1, 1995) through natural attrition, early retirement and other programs. The planned reductions included an estimated 38,300 non-civil servants expected to leave under voluntary separation agreements. This personnel restructuring program has now been completed. However, contracts remain which are not completed. In addition, collective agreements are used for early retirement and programs, which will lead to the establishment of new accruals when a fixed contract is finalized.

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The table below sets forth the payments made and the related accruals/ payables for future payments in respect of these staff reduction measures for the years 2002 and 2001:

	2002	2001
	(millions of )	
<b>Accruals/ payables, beginning of year</b>	<b>215</b>	<b>150</b>
Payments made (including payments made against accruals / payables)	(117)	(125)
Additions to accruals / payables	166	190
<b>Accruals/ payables, end of year</b>	<b>264</b>	<b>215</b>

During 2002, T-Systems announced the planned reduction of the number of its employees. At December 31, 2002, the remaining balance for this reduction was EUR 339 million, of which EUR 252 million relates to staff adjustments and EUR 87 million to other structural measures.

Of the decrease in accruals for loss contingencies, EUR 150 million relates to accruals for debt premiums at T-Mobile USA. These accruals are the result of the difference between the repayment amount and the higher fair value of bonds.

**(29) Liabilities**

	As of December 31, 2002				As of December 31, 2001			
	Total	of which due			Total	of which due		
		within one year	in one to five years	after five years		within one year	in one to five years	after five years
	(millions of )				(millions of )			
<b>Debt</b>								
Bonds and debentures	56,752	8,535	29,243	18,974	58,301	12,598	28,447	17,256
Liabilities to banks	6,292	1,341	3,534	1,417	8,730	754	4,984	2,992
	<b>63,044</b>	<b>9,876</b>	<b>32,777</b>	<b>20,391</b>	<b>67,031</b>	<b>13,352</b>	<b>33,431</b>	<b>20,248</b>
<b>Other</b>								
Advances received	414	228	186		371	357	14	
Trade accounts payable	3,833	3,807	26		4,827	4,792	35	
Liabilities on bills accepted and drawn					1	1		
Payables to subsidiaries	158	157	1		104	103	1	
Liabilities to other companies in which an equity interest is held	147	147			152	152		
Other liabilities	5,989	4,436	448	1,105	6,565	5,243	355	967
of which: from taxes	(1,159)	(1,159)			(2,200)	(2,200)		
of which: from social security	(153)	(153)			(131)	(131)		
	<b>10,541</b>	<b>8,775</b>	<b>661</b>	<b>1,105</b>	<b>12,020</b>	<b>10,648</b>	<b>405</b>	<b>967</b>
<b>Total liabilities</b>	<b>73,585</b>	<b>18,651</b>	<b>33,438</b>	<b>21,496</b>	<b>79,051</b>	<b>24,000</b>	<b>33,836</b>	<b>21,215</b>



The main items under bonds and debentures relate to old bonds issued by Deutsche Bundespost amounting to EUR 11.8 billion, and bonds issued by Deutsche Telekom International Finance B.V., Amsterdam, with the following conditions:

Structure of the 2000 global bond:

<b>Tranche</b>	<b>Nominal amount</b>	<b>Nominal amount in</b>	<b>Nominal interest rate</b>	<b>Maturity</b>
Euro	2,250,000,000	2,250,000,000	6.625%	2005
Euro	750,000,000	750,000,000	7.125%	2010
British pound	625,000,000	960,218,750	7.625%	2005
British pound	300,000,000	460,905,000	7.625%	2030
U.S. dollar	3,000,000,000	2,858,799,000	8.250%	2005
U.S. dollar	3,000,000,000	2,858,799,000	8.500%	2010
U.S. dollar	3,500,000,000	3,335,265,500	8.750%	2030
Japanese yen	90,000,000,000	722,952,000	2.000%	2005

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Structure of the 2001 eurobond:

<b>Tranche</b>	<b>Nominal amount</b>	<b>Nominal amount in</b>	<b>Nominal interest rate</b>	<b>Maturity</b>
Euro	4,500,000,000	4,500,000,000	6.375%	2006
Euro	3,500,000,000	3,500,000,000	7.125%	2011

After downgrading by Moody's from A3 to Baa1 in March 2002 and by Standard & Poor's from A- to BBB+ in April 2002, the coupons of the 2000 global bond and the 2001 eurobond increased by 0.5%. The change in the interest rate has already been included in the tables. If Deutsche Telekom is promoted back to at least A-level, the coupons will be reduced again by 0.5%.

Structure of the 2002 global bond:

<b>Tranche</b>	<b>Nominal amount</b>	<b>Nominal amount in</b>	<b>Nominal interest rate</b>	<b>Maturity</b>
Euro	2,000,000,000	2,000,000,000	8.125%	2012
Euro	2,500,000,000	2,500,000,000	7.500%	2007
U.S. dollar	500,000,000	476,466,500	9.250%	2032

The coupons of the 2002 global bond will increase by 0.5% if Deutsche Telekom is downgraded by Standard & Poor's and Moody's to below Baa1/BBB+ respectively.

Deutsche Telekom International Finance B.V. is a wholly owned subsidiary of Deutsche Telekom and the bonds issued by that subsidiary are fully and unconditionally guaranteed by Deutsche Telekom AG.

Breakdown of bonds and debentures as follows (in millions of €):

	<b>Effective interest rate</b>					<b>Total</b>
	<b>up to 6%</b>	<b>up to 7%</b>	<b>up to 8%</b>	<b>up to 9%</b>	<b>over 9%</b>	
Due in						
2003	5,880	2,557			98	8,535
2004	2,757	3,192	6,212	159		12,320
2005	2,123	2,450	960	2,859		8,392
2006	421	4,500				4,921
2007	500	500	2,500		110	3,610
after 2007	2,105	705	6,429	8,194	1,541	18,974
	<b>13,786</b>	<b>13,904</b>	<b>16,101</b>	<b>11,212</b>	<b>1,749</b>	<b>56,752</b>

Liabilities to banks (mainly loan notes and short-term loans) due in the next 5 years and thereafter are as follows:

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Due in	Amounts
	(millions of \$)
2003	1,341
2004	557
2005	2,582
2006	161
2007	234
after 2007	1,417
	<hr/>
	6,292
	<hr/> <hr/>

The average effective interest rates for our debt positions are:

for bonds and debentures	6.69% p.a. (2001: 6.81% p.a.)
for liabilities to banks	5.74% p.a. (2001: 5.82% p.a.)

Deutsche Telekom has agreements with a number of banks pursuant to which it can draw on credit facilities up to EUR 22.6 billion. These include syndicated credit facilities agreed by Deutsche Telekom AG and T-Mobile UK for EUR 12 billion (Deutsche Telekom syndicated credit) and EUR 4.2 billion (T-Mobile

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

UK syndicated credit). Deutsche Telekom AG serves as guarantor of the T-Mobile UK consortium credit. The level of the interest rates depends on Deutsche Telekom's rating, the amount of the syndicated credit and the LIBOR rate plus margin ranking to be applied, from 0.275% to 0.500%. The loan commitment fee is between 0.050% - 0.200% and also depends on Deutsche Telekom's rating. EUR 2.0 billion of the T-Mobile UK consortium credit has been used at December 31, 2002. This syndicated credit facility has an average interest rate of 4.69% excluding the loan commitment fee.

Part of the syndicated credit serves as collateral for Deutsche Telekom's commercial paper program. Deutsche Telekom cannot draw on the syndicated credit to the amount of the drawings on the commercial paper. At December 31, 2002, Deutsche Telekom issued commercial paper in the amount of EUR 1.5 billion. There were no additional outstanding debts relating to the Deutsche Telekom syndicated credit at the end of 2002. Deutsche Telekom's credit facilities continue to include short-term bilateral bank lines amounting to EUR 6.4 billion, of which, at the end of 2002, EUR 0.7 billion had been used for short-term drawings and EUR 0.8 billion for guarantees.

The development of debt is shown in millions of euros as follows:

(\*) unaudited

The Company's original debt was raised principally to finance the development of the communications networks in eastern Germany.

The reasons for the increase in debt in 2000 include the payment for UMTS licenses, the initial investment in T-Mobile USA/Powertel, the increase in the shareholding in MATAV and the acquisition of Slovenske Telekomunikacie and debis Systemhaus.

The increase in debt in 2001 was mainly attributable to the acquisition and consolidation for the first time of T-Mobile USA/Powertel.

Debt decreased in 2002, despite the acquisition of the remaining shares in debis Systemhaus and Ben, by around EUR 4 billion, mainly resulting from cash generated from operations, sales of real estate and financial assets and changes in foreign currency rates.

Liabilities include borrowings of EUR 20,777 million (2001: EUR 17,799 million) denominated in foreign currencies.

Certain debt agreements contain affirmative and negative covenants, including financial covenants, and provide for various events of default. As of December 31, 2002, Deutsche Telekom and its subsidiaries were in compliance with these covenants. Additionally, certain subsidiaries of Deutsche Telekom are or may be subject to debt covenants that restrain the payment of dividends or the making of loans to Deutsche Telekom AG. With regard to non-wholly owned subsidiaries, agreements with minority shareholders or generally applicable principles of law relating to the rights of minority shareholders may in some instances restrict the ability of Deutsche Telekom to direct the payment of dividends or making of loans from those subsidiaries to Deutsche Telekom AG. The ability of subsidiaries to pay dividends may be subject to limitations relating to the availability of sufficient retained earnings or other local law requirements of general applicability.

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Other liabilities:

	As of December 31,	
	2002	2001
	(millions of )	
Interest	1,556	1,586
Rental and leasing obligations	573	569
Loan notes	842	659
Liabilities to employees	164	153
Other	2,854	3,598
	<b>5,989</b>	<b>6,565</b>

Other liabilities include taxes of EUR 1,159 million (Dec. 31, 2001: 2,200 million) and social security liabilities of EUR 153 million (Dec. 31, 2001: EUR 131 million).

Liabilities in the amount of EUR 0 million (2001: EUR 120 million) payable by subsidiary companies to banks and third parties are collateralized. Deutsche Telekom AG has provided no collateral against its liabilities.

In accordance with Postreform II (§ 2 (4) of the Stock Corporation Transformation Act Postumwandlungsgesetz), the Federal Republic is guarantor of all Deutsche Telekom AG's liabilities which were outstanding at January 1, 1995.

**NOTES TO THE CONSOLIDATED STATEMENTS OF CASH FLOWS**

The consolidated statements of cash flows has been prepared in conformity with International Accounting Standard (IAS) No. 7, Cash Flow Statements. Besides IAS 7, German Accounting Standard (DRS) No. 2, cash flow, as approved by the German Standardization Council (DSR), is also used in preparing the consolidated statement of cash flows.

Liquid assets and short-term investments with original maturities of less than 3 months at the date of purchase are considered cash equivalents in the preparation of the consolidated statements of cash flows. These current cash and cash equivalents decreased by EUR 1.0 billion to EUR 1.7 billion in 2002.

**(30) Net Cash Provided by Operating Activities**

Net cash provided by operating activities in 2002 amounted to EUR 12.5 billion. This represents an increase of EUR 0.5 billion compared with the previous year. This improvement is attributable in part to lower net interest payments resulting from the reversal of hedges, increases in accruals of EUR 1.4 billion and the change in non-cash transactions of EUR 2.3 billion. These are mainly the result of valuation adjustments for loans to associated companies of Kabel Deutschland GmbH (EUR 0.3 billion) and for the net carrying amount of Deutsche Telekom's stake in France Telecom (EUR 0.6 billion).

**(31) Net Cash Used for Investing Activities**

Net cash used for investing activities amounted to EUR 10.1 billion compared with EUR 5.4 billion in the previous year. The cash outflow of EUR 14.6 billion for investments in noncurrent assets is mainly attributable to investments in property, plant and equipment of EUR 6.8 billion, the full acquisition of T-Systems ITS GmbH (formerly debis Systemhaus) amounting to EUR 4.7 billion and the purchase of Ben for EUR 1.7 billion.

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Disposals resulted in a cash inflow of EUR 3.1 billion. The main factors here are the sale of real estate amounting to EUR 1.3 billion and the sale of shares in T-Online for EUR 0.7 billion. Disposals also included the sale of the shares in France Telecom and Satelindo for a total of EUR 0.6 billion.

Compared with the previous year, this results in a reduction of EUR 3.1 billion in cash outflows for investments in property, plant and equipment and a decrease in cash inflows from disposals, which in the previous year mainly related to the sale of the shares in Sprint (EUR 3.4 billion) and WIND (EUR 2.7 billion) and the sale of the cable company in Baden-Wuerttemberg (EUR 0.9 billion).

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(32) Net Cash Provided by (Used for) Financing Activities**

Net cash used in financing activities decreased in 2002 by EUR 1.4 billion compared with 2001 to EUR 3.4 billion. 2002 financing activities included approximately EUR 1.8 billion of cash used to reduce debt, and EUR 1.6 billion of cash used to pay the 2001 dividend to shareholders.

**OTHER INFORMATION****(33) Guarantees and Commitments, and Other Financial Obligations***Guarantees and Commitments*

	As of December 31,	
	2002	2001
	(millions of )	
Guarantees	47	224
Liabilities arising from guarantee agreements	927	66
	<b>974</b>	<b>290</b>

The increase in liabilities from guarantee agreements relates mainly to obligations and indemnifications of T-Mobile International AG in connection with a EUR 909 million QTE (Qualified Technology Equipment) lease financing transaction.

Deutsche Telekom AG, DaimlerChrysler Services AG, Berlin and Compagnie Financiere et Industrielle des Autoroute S.A., Sevres Cedex (Cofiroute, France) as a consortium ( TollCollect ) have reached an agreement with the Federal Republic of Germany for the development and operation of a system for the recording and collection of toll charges for commercial vehicles. Deutsche Telekom and DaimlerChrysler Services AG, Berlin, each hold a 45% stake in the consortium and Cofiroute 10%. Under the terms of the agreement, the consortium has guaranteed successful completion of the system for the recording and collection of toll charges. This project consists of various phases with corresponding penalties for delayed completion. The system is scheduled to start operation in August 2003. The consortium has also guaranteed the continued successful operation of the system. An operating company will receive a defined level of remuneration for this purpose. If the development of the system does not proceed according to plan or if the system does not work after the start of operation, the consortium will be liable to pay contractual penalties, the amount of which cannot be reasonably estimated. This entails risks of joint and several liability.

*Other Financial Obligations*

	As of December 31, 2002		As of December 31, 2001	
	of which due		of which due	
	in the following	from second year after the	in the following financial year	from the second year after the
<b>Total</b>			<b>Total</b>	

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	financial year	balance sheet date	balance sheet date	balance sheet date	balance sheet date	balance sheet date
(millions of \$)						
Present value of payments to special pension fund	9,001	831	8,170	9,372	845	8,527
Purchase commitments for interests in other companies	826	218	608	6,872	5,022	1,850
Obligations under rental and lease agreements	10,050	1,813	8,237	6,839	1,269	5,570
Purchase commitments for capital projects in progress including obligations arising from future expenditure	1,213	1,141	72	3,201	3,142	59
Commitments arising from transactions not yet settled	475	364	111	444	315	129
<b>Total other financial obligations</b>	<b>21,565</b>	<b>4,367</b>	<b>17,198</b>	<b>26,728</b>	<b>10,593</b>	<b>16,135</b>

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The present value of payments that Deutsche Telekom is required to make in accordance with Postreform II to the Company's special pension fund for civil servants, or its successor, on the basis of the 1998 life expectancy tables prepared by Prof. Klaus Heubeck amounted to EUR 9.0 billion at December 31, 2002, of which EUR 3.8 billion relates to future years of service of the active civil servants.

In 2002, purchase commitments for interests in other companies consist mainly of EUR 490 million relating to the obligation to acquire additional shares in PTC (EUR 128 million) and obligations of T-Mobile and T-Online in venture funds totaling approximately EUR 160 million. The decrease in purchase commitments for interests in other companies relate mainly to the exercise of the option held by DaimlerChrysler AG, Stuttgart, to sell Deutsche Telekom the remainder of its shares in T-Systems ITS GmbH, Leinfelden-Echterdingen (formerly debis Systemhaus) (EUR 4.7 billion); this option was exercised at the beginning of 2002. Furthermore, T-Mobile International AG fulfilled its obligation to take over additional shares in Ben in September 2002. The exercise price for this financial obligation as reported here in the previous year was EUR 1.7 billion.

During 2002, the Company sold real estate to a newly established real estate fund for EUR 525 million. In connection with the sale, the Company has committed to lease back the real estate sold for a period of 15 years. The Company has a call right to acquire all the shares of the real estate fund after 10 years, and the shareholders of the fund have the put right to compel the Company to acquire all the shares of the real estate fund after 16 years. The call and put prices are formula based, determined on the then cash flow multiples generated by the transferred real estate, and adjusted for outstanding mortgage loans at the time of exercise. Based on current market conditions, the undiscounted future put price would be approximately EUR 420 million, net of mortgage loans assumed of approximately EUR 210 million.

The increase in obligations under rental and lease agreements relates mainly to sale and lease back transactions for real estate.

The decrease in purchase commitments for capital projects in progress relates mainly to Deutsche Telekom AG. The decrease is mainly attributable to the reduction in investment activities.

The commitments arising from transactions not yet settled relate mainly to purchase commitments for UMTS and 3G equipment by T-Mobile to Siemens, Nokia and Nortel (total of EUR 354 million). There are detailed agreements covering the purchase quantities and periods.

***Litigation, Claims and Assessments***

A number of purported class action lawsuits have been filed and consolidated in the United States District Court for the Southern District of New York by or on behalf of purported purchasers of the ADSs issued pursuant to a registration statement on Form F-3 filed with the Securities and Exchange Commission on May 22, 2000, and pursuant to a prospectus dated June 17, 2000, and purported purchasers of our ADSs during the period from June 19, 2000, to and including February 21, 2001. The operative complaint in these consolidated actions asserts claims against the Company and the former Chairman of the Management Board, and others, under U.S. federal securities statutes based on allegations that statements made in the registration statement and prospectus were materially false and misleading because Deutsche Telekom allegedly failed adequately to disclose detailed information relating to merger negotiations with VoiceStream Wireless Corporation, and allegedly overstated the value of its real estate portfolio. The Court has certified the action as a class action and defined the class to include all purchasers of its ADSs during the period from June 19, 2000, to and including February 21, 2001.

Approximately 260 lawsuits have been filed in Germany by purported purchasers of its shares sold pursuant to prospectuses dated May 28, 1999 and May 26, 2000. These lawsuits allege that the book values the Company recorded for its real property portfolio were improperly established and maintained under German accounting principles. In many of these lawsuits, claims have also been made with respect to the VoiceStream transaction analogous to those made in the purported U.S. class action lawsuits described above. These lawsuits are pending before the District Court in Frankfurt am Main. It is too early for the Company to express a view of the possible

outcome of the lawsuits. The presiding judge has issued a statement describing his preliminary view that it will be necessary to take evidence by obtaining an expert opinion. The presiding judge also stated that he is inclined to order a stay of the civil litigation until the criminal proceedings in the pertinent matter will be resolved. The court will probably decide on the stay in the course of the next months.

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The Company is contesting each of the aforementioned lawsuits vigorously. Because the lawsuits, which in the aggregate involve substantial damage claims, are in their preliminary stages, the Company is not in a position to predict their outcome or impact. However, the Company believes that the allegations in the lawsuits do not provide a basis for the recovery of damages because all required disclosures were made on a timely basis.

On October 3, 2002, T-Mobile UK Ltd. (T-Mobile UK) commenced proceedings in London, United Kingdom, against its joint venture partners, Bluebottle UK Ltd. and Bluebottle Investments S.A. (which are both companies affiliated with the Virgin Group of companies) and also against the joint venture company itself, Virgin Mobile Telecomms Ltd. (Virgin Mobile). As part of the joint venture, T-Mobile UK is required to pay Virgin Mobile a lump sum per month for each Virgin Mobile customer. Virgin Mobile is required to pay T-Mobile UK a fee per minute used by its customers on the T-Mobile UK network. The complaint contained a number of allegations, including the right of T-Mobile UK to terminate the Joint Venture through a no-fault termination process. Virgin Mobile counter-claimed for payment of sums that Virgin Mobile claimed had been improperly withheld by T-Mobile UK in relation to Virgin Mobile customers who had not made an outbound call for a certain period of time. Virgin Group has filed a separate proceeding against T-Mobile UK seeking certain declarations that alleged breaches by T-Mobile UK of the Shareholders Agreements governing the joint venture arrangement have occurred and that the Virgin Group is consequently entitled to serve on T-Mobile UK a compulsory sale notice requiring it to sell its shares in Virgin Mobile to Virgin Group for a nominal sum. The Virgin Group statement of claim also asks for further or other relief and costs but no quantification of these has been made. On March 6, 2003, the High Court in London rendered a decision in the action filed by T-Mobile UK and the counter claim filed by Virgin Mobile and held, in relevant part, that T-Mobile UK did not have the right to terminate the joint venture arrangement, and that it was unreasonable to expect T-Mobile UK to continue to pay Virgin Mobile with respect to customers that have been inactive for a significant period. Accordingly, under the judgment, the joint venture arrangement continues, but T-Mobile UK's payment obligations with respect to Virgin Mobile inactive customers have been resolved in T-Mobile UK's favour. The payments claimed by Virgin Mobile in respect of inactive customers have not been paid by T-Mobile UK but appropriate financial provisions have been and continue to be made. Oral applications for leave to appeal were made on March 14, 2003 by both T-Mobile UK and Virgin Mobile but were declined. Those applications for leave to appeal are likely to be renewed before the Court of Appeal, but T-Mobile UK is still assessing the full impact of both decisions and is in the process of determining whether or not to pursue the appeal of certain aspects of the ruling. The declarations action for alleged breach filed by the Virgin Group will not be heard by the Court until late 2003.

The Bonn public prosecutor is conducting an investigation (*Ermittlungsverfahren*) into allegations in the press and elsewhere asserting that the book values the Company recorded for its real property portfolio and fixed assets in general, including technical equipment and machinery, have been improperly established and maintained under applicable accounting principles and so were substantially overvalued in the 1995 opening balance sheet and in later balance sheets. The Bonn public prosecutor has notified the Company that his investigation also goes into whether the Company underpaid its German corporate income and trade taxes because amortization and depreciation were higher than they should have been as a result of the alleged overstatement. The Company believes that the book values of the fixed assets have been correctly presented in accordance with applicable accounting principles, and dispute allegations to the contrary. The Company has nonetheless been cooperating fully in the investigation and is interested in seeing it expeditiously resolved. According to press reports, the public prosecutor indicated in early 2003 that his investigation would also cover the allegations described in the preceding paragraph. The Company cannot offer assurances as to the timing or outcome of the prosecutor's investigation. Deutsche Telekom believes that the investigation is being conducted with regard to certain individuals and is not directed against it. Adverse consequences for Deutsche Telekom could follow if any of the individuals who are or who become the subject of the investigation were found to have violated the law.

The Bonn public prosecutor is also conducting other investigations. One investigation concerns alleged breaches of duty by members of the Supervisory Board and past and present members of the Management Board with regard to our 2001 stock option program, the issuance of stock options and other management compensation arrangements with the Management Board, benefits paid or to be paid to the former Management Board chairman in connection with his withdrawal from the company and other circumstances of his withdrawal. Another investigation concerns allegations that members and former members of the



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Company's Management Board breached their duties by causing the Company to pay excessive consideration for VoiceStream and Powertel. The Company understands both of these investigations are being conducted with respect to individuals and are not directed against the Company as a corporate entity. In each case, the Company believes that the Company and its board members acted appropriately. Adverse consequences for the Company could follow from these investigations, however, if the individuals who are the subjects of the investigations are found to have violated the law. The Company is cooperating in the investigations.

The Bonn public prosecutor is further investigating allegations in the press and elsewhere asserting that the Company is involved in systematic wrongful billing. The Company has denied these allegations, but has been cooperating fully in the investigation and is interested in seeing it expeditiously resolved. The Company cannot offer assurances as to the timing or outcome of the prosecutor's investigations.

In September 1998, Deutsche Post AG commenced an arbitration proceeding seeking contributions from the Company relating to the cost of employee housing for former Deutsche Bundespost employees, including a number of its employees. In 1995, responsibility for the housing of former employees of Deutsche Bundespost was assigned to Deutsche Post AG. The parties have different views as to the amount the Company is obliged to pay as cost reimbursement for the use of such employee housing for its employees. Deutsche Post AG currently is seeking payment in the amount of EUR 114 million from the Company, although the Company expects that Deutsche Post AG may claim further amounts in the event that its initial claim is successful. In March 2000, the Company raised counterclaims in the amount of EUR 62.6 million reclaiming down payments from 1995 and 1996. The outcome of the arbitration proceeding is uncertain.

Media reports have suggested that radio frequency emissions from wireless handsets and cell sites may raise various health concerns, including cancer, and may interfere with various electronic medical devices, including hearing aids and pacemakers. Research and studies are ongoing. Whether or not such research or studies conclude there is a link between radio frequency emissions and health, these concerns over radio frequency emissions may discourage the use of wireless handsets and may result in significant restrictions on the location and operation of cell sites, either or both of which could have a material adverse effect on the Company's or on T-Mobile USA's results of operations. T-Mobile USA is subject to current, and potentially future, litigation relating to these health concerns. Several amended class action lawsuits have been filed against T-Mobile USA and several other wireless service operators and wireless phone manufacturers, asserting products liability, breach of warranty and other claims relating to radio frequency transmissions to and from wireless handsets. The complaints seek substantial money damages as well as injunctive relief. The defense of these lawsuits may divert management's attention, and T-Mobile USA may be required to pay significant awards or settlement and may incur significant expenses in defending these lawsuits. In addition, T-Mobile USA could be subject to potential litigation, legislation or adverse publicity relating to damage caused by persons who use mobile telephones while driving.

In April 2001, QPSX Europe GmbH filed suit for a permanent injunction with the District Court in Munich (*Landgericht Munich*) against the Company and Siemens AG, alleging that the companies are both infringing on plaintiff's patent by providing services using Asynchronous Transfer Mode (ATM) technology. Since ATM technology is used in a number of products and services which the Company offers, e.g. T-DSL and T-ATM, an adverse outcome in this proceeding could have a substantial adverse effect on its business.

**(34) Derivative Financial Instruments**

The Company uses derivative financial instruments for the purpose of hedging interest rate and currency exposures which arise from its ongoing business operations. The Company's policy is to hold or issue derivative financial instruments to eliminate risk exposures instead of creating new risk. Derivative financial instruments are subject to internal controls.

Derivatives classified as hedging instruments are those entered into for the purpose of matching or eliminating risk from potential movements in interest rates and foreign exchange rate inherent in the Company's assets and liabilities. A derivative is designated as a hedge where there is an offset between the effects of potential movements in the derivative and designated underlying asset, liability or position being hedged. Such

derivatives are reviewed regularly for their effectiveness as hedge instruments. Derivative instruments designated as hedges are accounted for on the same basis as the hedged item.

The main interest rate instruments used are interest rate swaps. These are entered into with the aim of transforming the coupons on bonds, and the interest rates on loans and financial assets, in accordance with a

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mix of fixed and floating rate interest instruments that is laid down once a year. Interest rate swaps are designated as hedging instruments for specific liabilities or groups of similar liabilities. Cross currency interest rate swaps usually synthetically convert foreign currency bonds or medium-term notes into target currencies.

Gains or losses related to changes in the value of interest rate swaps are generally not recognized. Interest rate swaps which are not designated as hedging instruments for balance sheet assets and liabilities (which are mainly hedges of planned future transactions) are marked to market and resultant negative values are accrued and included as a component of net interest expense; gains are recognized upon realization. Unrealized gains and losses from changes in market value are netted currency for currency and are assigned to portfolios and the resultant net loss is accrued. The interest differential to be paid or received on interest rate swaps is recognized in the statement of earnings, as incurred, as a component of net interest expense. Gains or losses on interest rate swaps released prior to their maturity are recognized currently in net interest expense.

The Company uses foreign currency forward contracts and foreign currency options purchased as well as cross currency interest rate swaps to reduce fluctuations in foreign currency cash flows related to capital expenditures and financial liabilities. Foreign currency forward contracts hedging firm commitments to invest in a foreign entity are not recognized at the balance sheet date. The investment in the purchased entity is capitalized using the foreign exchange rate fixed by the foreign currency forward contract. The Company purchases options to hedge firm commitments to invest in a foreign entity. A purchased option is included in other assets and measured at historical cost. Upon exercise of the option, the premium is included in the purchase cost of the asset. Gains and losses resulting from foreign currency forward contracts, cross currency interest rate swaps and foreign currency financing which relate to the net investments in foreign entities are recorded in the cumulative translation adjustment account.

Foreign currency forward contracts hedging other payments and receipts are assigned to foreign currency portfolios categorized by foreign currency type with the related financial instruments. These portfolios are marked to market at the balance sheet date and resultant negative portfolio values are accrued under other liabilities. Valuation gains and losses are netted portfolio for portfolio. An accrual for loss contingencies is established for each portfolio for the amount of the excess loss. Net gains are not recognized.

The forward foreign exchange contracts fix amounts the Company is required to pay in the future in euro for a contractually fixed amount of foreign currency forward contracts and currency options.

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The following is a summary of the contract or notional principal amounts outstanding and the average interest paid/received at December 31, 2002 and 2001:

	As of December 31, 2002				As of December 31, 2001			
	Maturity	Notional	Average	Average	Maturity	Notional	Average	Average
		amount	interest	interest		amount	interest	interest
	(millions of )	rate paid	rate received		(millions of )	rate paid	rate received	
<b>Interest rate swaps (EUR)</b>								
Receive fixed, pay variable	2003-2010	12,019	3.26%	4.44%	2002-2010	9,686	3.72%	4.69%
Forward receive fixed, pay variable	2005	820	EURIBOR6M	4.21%				
Receive variable, pay fixed	2003-2010	4,652	5.23%	3.07%	2002-2010	3,251	5.73%	3.25%
<b>Interest rate swaps (USD)</b>								
Receive fixed, pay variable	2003-2008	1,144	2.11%	8.00%	2002-2030	11,249	2.08%	7.92%
Receive variable, pay fixed					2002-2008	595	6.23%	2.44%
Forward receive variable, pay fixed	2007	2,859	5.07%	USDL6M				
<b>Interest rate swaps (GBP)</b>								
Receive variable, pay fixed	2003-2006	1,575	5.91%	3.94%	2002-2030	9,243	6.37%	4.20%
Forward receive variable, pay fixed	2005	307	6.04%	GBP6MLibor	2004-2005	1,642	6.06%	GBP6MLibor
<b>Interest rate swaps (JPY)</b>								
Receive fixed, pay variable	2005	723	0.32%	1.50%	2005	778	0.34%	1.50%
<b>Interest rate swaps (CZK)</b>								
Receive fixed, pay variable	2004	13	3.18%	8.14%	2004	13	4.88%	8.14%
<b>Interest rate swaps</b>								



<b>(HUF)</b>								
Forward receive variable, pay fixed	2006	269	9.25%	BUBOR6M				
<b>Interest rate caps / collars</b>	2003	38			2002-2003	400		
<b>Cross currency interest rate swaps sold</b>	2003-2032	6,437	5.29%	3.05%	2002-2030	15,129	4.00%	1.52%
<b>Forward cross currency interest rate swaps sold</b>	2006	252	BUBOR6M	EURIBOR6M				
<b>Foreign currency forward contracts</b>								
Forward purchases	2003-2008	1,955			2002-2008	229		
Forward sales	2003-2006	2,917			2002-2004	12,336		
Currency options	2003	4			2002	15		

The notional amounts of the derivative financial instruments do not generally represent amounts exchanged by the parties and, therefore, are not a direct measure of the exposure of the Company through its use of derivatives. The amounts exchanged are calculated through reference to the notional amounts and by other terms of the derivatives, such as interest rates, exchange rates or other indices.

### (35) Segment Reporting

Deutsche Telekom applies SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* and the German Accounting Standard Segment Reporting (DRS 3) for the calculation of segment information. In accordance with the aforementioned, companies must disclose information on their operational segments in accordance with their internal reporting structures. Under SFAS No. 131 and DRS 3, Deutsche Telekom has the following operational segments for which reporting is required: T-Com, T-Systems, T-Mobile and T-Online. The segments for which reporting is required are strategic divisions which differ in their products and services, their relevant sub-markets, the profile of their customers and their regulatory environment.

The valuation methods used for the Group segment reporting correspond mainly to those used in the German consolidated financial statements. Deutsche Telekom evaluates the segments' performance based on income before taxes; the operational figures EBIT and EBITDA are also used. Based on income before taxes, EBIT does not include extraordinary income (losses) or net financial income (expense). EBITDA additionally excludes depreciation and amortization. As in 2001, no single matter in the 2002 financial year was shown in the Deutsche Telekom Group's consolidated financial results as extraordinary income / loss; the expenses for the initial public offering of T-Online and the planned initial public offering of T-Mobile International AG accounted for the extraordinary loss of EUR 159 million in 2000.

Revenues generated and goods and services exchanged between segments are, as far as possible, calculated on the basis of market prices. Income taxes and taxes chargeable as expense are not assigned to individual segments. With the exception of depreciation and amortization, no major noncash items are shown

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in the segments. The income (loss) related to associated and related companies relates to income from investments and associated companies, as well as write-downs of financial assets and marketable securities.

Segment assets under segment reporting include the remaining book value of property, plant and equipment, intangible assets and financial assets. Segment investments are defined as additions to noncurrent assets. In addition, the segment assets and segment investments are shown by geographical regions; assignment to the individual regions is generally by the location of the asset. Refer to note (1) for the presentation of revenue by regions. In accordance with DRS 3, liabilities have been assigned to the segments since the 2000 financial year. As part of Group segment reporting, these liabilities include debt and other liabilities, excluding tax liabilities.

		Net revenue	Revenue between segments	Depreciation and amortization expense	Interest income (expense)	Income related to associated companies	Income (loss) before taxes	Segment assets	Segment investment	Segment liabilities	Segment Employees <sup>(1)</sup>
		(millions of \$)									
<b>T-Com</b>	2002	25,422	4,776	(5,537)	(565)	(304)	3,539	33,778	3,272	12,983	152,836
	2001	25,028	4,391	(5,443)	(350)	(509)	4,614	36,109	6,128	13,266	148,247
	2000	24,455	4,927	(6,417)	(793)	(214)	4,904				
<b>T-Systems</b>	2002	7,793	3,517	(2,616)	(98)	(20)	(1,981)	6,646	3,551	5,268	43,482
	2001	8,316	3,583	(1,372)	102	13	(382)	5,807	1,525	5,022	41,994
	2000	6,021	3,791	(807)	(114)	15	2,420				
<b>T-Mobile</b>	2002	18,229	1,506	(27,285)	(1,005)	(427)	(23,679)	57,655	5,766	20,224	38,943
	2001	12,994	1,643	(6,324)	(3,008)	(204)	(6,399)	86,704	28,418	21,657	30,124
	2000	8,994	1,362	(2,337)	(1,370)	(127)	(2,350)				
<b>T-Online</b>	2002	1,672	158	(208)	131	(121)	9	934	171	265	2,765
	2001	1,338	111	(189)	168	(134)	(233)	983	118	258	3,008
	2000	1,038	90	(93)	127	(9)	2,628				
<b>Other</b>	2002	573	3,838	(1,298)	(2,510)	(1,093)	(4,454)	12,978	551	34,539	17,870
	2001	633	4,481	(1,447)	(1,102)	(375)	352	17,237	1,618	38,846	18,287
	2000	431	4,770	(1,324)	(1,018)	2,188	701				
<b>Reconciliation</b>	2002		(13,795)	64	(1)	(9)	(220)	(465)	(149)	(853)	
	2001		(14,209)	(446)	52	(1)	(456)	(124)	(109)	(2,198)	
	2000		(14,940)	(2,013)	71	14	(1,970)				
<b>Group</b>	2002	53,689		(36,880)	(4,048)	(1,974)	(26,786)	111,526	13,162	72,426	255,896
	2001	48,309		(15,221)	(4,138)	(1,210)	(2,504)	146,716	37,698	76,851	241,660
	2000	40,939		(12,991)	(3,097)	1,867	6,333				

(1) Average figures for the year  
**Segments by Geographic Area**

	Segment assets		Segment investments	
	December 31, 2002	December 31, 2001	December 31, 2002	December 31, 2001
	(millions of \$)			
Germany	51,707	55,490	6,883	7,669
European Union (excluding Germany)	20,370	26,499	2,694	1,908
Rest of Europe	12,006	12,218	1,173	1,952
North America	26,448	51,527	2,228	25,519

Other	995	982	184	650
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Group</b>	<b>111,526</b>	<b>146,716</b>	<b>13,162</b>	<b>37,698</b>
	<b><u>          </u></b>	<b><u>          </u></b>	<b><u>          </u></b>	<b><u>          </u></b>

**T-Com**

The T-Com division is one of the largest fixed-network operators in Europe, operating around 57.5 million lines including ISDN channels. In Germany, T-Com serves residential customers and small and medium-sized business customers with 51 million lines including ISDN channels and a broad range of products and services. As a full-service provider, T-Com offers approximately 440,000 small and

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medium-sized companies integrated solutions consisting of information technology and telecommunications. T-Com is present in the markets of Central and Eastern Europe with shareholdings in Matav (Hungary), Hrvatske telekomunikacije (Croatia) and Slovenske Telekomunikacije (Slovakia). At the end of the year under review, the division had approximately 148,900 employees throughout Europe.

The increase of EUR 394 million in net revenue to EUR 25,422 million relates mainly to the first full-year consolidation of Hrvatske telekomunikacije in the 2002 financial year. Furthermore, decreases in call revenues were offset in the period under review by the increase in access revenues, particularly as a result of the growth in the number of advanced ISDN channels and T-DSL lines. This positive development of net revenue was offset by price measures for domestic traffic terminating in the mobile and fixed networks, direct network interconnection between mobile communications carriers and competitors, as well as the deconsolidation of the cable company in Baden-Wuerttemberg in 2001.

Revenue from business with other segments amounting to EUR 4,776 million relates mainly to network and support services billed by T-Com to other segments and the provision of fixed-network terminal equipment for other segments.

Depreciation and amortization in the period under review was slightly higher than in the previous year. This is mainly attributable to the first full-year consolidation of Hrvatske telekomunikacije in the 2002 financial year. The net interest expense reflects the level of financial liabilities assigned to the segment. The increase in net interest expense compared with the previous year is predominantly a result of less favorable interest rates. The decrease in the loss related to associated and related companies is mainly attributable to lower valuation adjustments for loans to associated companies of Kabel Deutschland GmbH compared with the previous year. Excluding these factors in 2002 and 2001, the result related to associated and related companies remained almost stable at the level of the previous year.

Income before taxes of EUR 3,539 million in this segment was lower than in the previous year. Besides the aforementioned changes in revenue, depreciation and amortization, results related to associated and related companies and net interest expense, this development is particularly attributable to other operating income relating to the sale of the cable companies in Baden-Wuerttemberg and the regional Kabelservice companies in North-Rhine Westphalia and Hesse in 2001 for EUR 997 million. There were no comparable activities in the year under review.

The decrease in segment assets to EUR 33,778 million relates in particular to a decrease in property, plant and equipment at T-Com. This development is mainly attributable to scheduled depreciation of property, plant and equipment. The investments in T-Com's segment assets were mainly made in technical equipment and advance payments and construction in progress, as in the previous year. Capital expenditure decreased in comparison with the previous year. Segment liabilities consist mainly of financial liabilities.

**T-Systems**

T-Systems serves Deutsche Telekom's domestic and international systems customers. T-Systems offers comprehensive services from the field of information technology (IT) and telecommunications (TC) as well as e-business solutions from the IT / TC convergence sector. The legal integration of T-Systems ITS GmbH (formerly debis Systemhaus) was completed in the year under review; Deutsche Telekom acquired the remaining 49.9% of the shares in the company from DaimlerChrysler and merged T-Systems ITS GmbH with T-Systems International GmbH at the end of 2002. The area Carrier Services National has been part of the T-Com division since January 1, 2002. In return, the area Carrier Services International, previously part of T-Com, has been reassigned to the T-Systems segment. The figures for the previous year have been adjusted accordingly.

Net revenue in 2002 was EUR 7,793 million, EUR 523 million lower than the previous year's figure of EUR 8,316 million. This decrease is mainly attributable to price reductions in the area of international carrier services, limited orders from key account customers due to the difficult economic situation and the slow

development of data communications business in network service business. Furthermore, the sale of businesses in France and in the Netherlands had a negative impact on the development of net revenue.

Revenue from business with other segments also decreased slightly to EUR 3,517 million. T-Systems CSM and T-Systems Nova in particular contributed to the decrease in revenue. T-Systems CSM and T-Systems Nova mainly bill IT / development services to the other segments.

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The increase of EUR 1,244 million in depreciation and amortization is particularly attributable to nonscheduled depreciation and amortization of goodwill and property, plant and equipment amounting to EUR 600 million. Furthermore, effects were also recorded from the increased level of capital expenditure in 2001 and the correspondingly increased level of depreciation and amortization in 2002, and the nonscheduled depreciation and amortization of submarine cables in the North Atlantic / Pacific as well as additional amortization of goodwill relating to the acquisition of the remaining 49.9% of the shares in T-Systems ITS GmbH. Net interest expense in the year under review amounted to EUR 98 million, compared with net interest income of EUR 102 million in the previous year. This was mainly attributable to the loan-based financing of the acquisition of the remaining shares in T-Systems ITS GmbH.

Segment assets amounting to EUR 6,646 million consist mainly of intangible assets, in particular goodwill relating to T-Systems ITS. The increase in segment assets in 2002 is mainly attributable to the considerably increased investment in intangible assets compared with the previous year as a result of the acquisition of the remaining shares in T-Systems ITS GmbH in the first quarter of 2002. Segment liabilities consist mainly of financial liabilities.

**T-Mobile**

The business of T-Mobile combines all the activities of the T-Mobile International group. Via its subsidiaries, T-Mobile offers a transatlantic GSM mobile communications network and thus the advantages of a uniform technical platform, mainly for a broad range of customers in Germany, the United Kingdom, the USA, Austria, the Czech Republic and the Netherlands. T-Mobile International also holds stakes in Poland, Russia and Canada. Besides T-Mobile International AG as the parent company, the companies fully consolidated include T-Mobile Deutschland, T-Mobile UK, T-Mobile USA / Powertel, T-Mobile Austria, RadioMobil, and Ben.

The increase in net revenue by EUR 5,235 million to EUR 18,229 million reflects in particular the considerable increase in the number of subscribers in almost all the mobile communications networks under T-Mobile's majority control. Furthermore, the full-year consolidation of T-Mobile USA, Inc./ Powertel and RadioMobil also had a positive impact on net revenue in 2002. These companies were only consolidated for seven months (T-Mobile USA, Inc./ Powertel) and nine months (RadioMobil) respectively in 2001. The consolidation of Ben for the first time at the end of September 2002 contributed to the remaining increase.

Revenue of EUR 1,506 million from business with other segments was primarily generated within Germany through network interconnection services (so-called mobile terminated calls).

The increase in depreciation and amortization in the 2002 financial year is mainly attributable to the need for write-downs on goodwill at T-Mobile USA and Ben and on mobile communications licenses at T-Mobile USA and T-Mobile UK, amounting to EUR 20,795 million, resulting from the strategic review. In the previous year, by contrast, this figure consisted merely of a nonscheduled amortization of goodwill of EUR 1,040 million relating to the establishment of the name T-Mobile as a global brand for mobile communications at T-Mobile UK and T-Mobile Austria. Furthermore, changes in the composition of the T-Mobile group, relating to the acquisition of T-Mobile USA / Powertel and RadioMobil in 2001 and the consolidation of Ben Nederland Holding B.V. for the first time in 2002, also contributed to the increase.

The improved net interest expense, from EUR 3,008 million in the previous year to EUR 1,005 million in 2002, is mainly attributable to a reduction in interest expense at T-Mobile International AG relating to the conversion of loans from Deutsche Telekom AG to shareholders' equity in the previous year. In this respect, the early repayment penalty of EUR 569 million included in the interest payments in the previous year no longer applies in the year under review. Changes in the composition of the T-Mobile group had an offsetting effect in 2002, leading to increased interest expense.

The consolidation of Ben for the first time in the 2002 financial year and the first full-year consolidation of T-Mobile USA / Powertel and RadioMobil in 2002 also had an impact on income before taxes. The increase in subscriber numbers at T-Mobile USA and the corresponding increase in advertising and marketing expenses also

continued to have an impact on the development of income before taxes.

The decrease in segment assets is mainly attributable to the need for write-downs on intangible assets, resulting from the strategic review. Investments in the segment in 2002 relate in particular to investments in property, plant and equipment and intangible assets. The decrease in segment liabilities is mainly a result of the considerable reduction of debt.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**T-Online**

The T-Online segment is one of the leading online providers in Europe, measured in terms of subscriber numbers and revenue. It is represented with companies in France, Spain, Portugal, Austria and Switzerland. T-Online operates a combined business model comprising access and non-access activities (advertising / e-commerce). Besides the T-Online group, the T-Online segment also includes DeTeMedien.

The net revenue of the T-Online segment increased further in the year under review by EUR 334 million to EUR 1,672 million and thus continued the trend of 2000 and 2001. The positive developments in both the access and non-access business areas make particular contributions to the revenue growth in 2002. The increase in the number of subscribers in the access area and increased portal revenues in the non-access area made particular contributions to the continued positive development of revenues in 2002.

T-Online also recorded a slight increase in revenue of EUR 47 million from the internal provision of services between segments.

The segment generated income before taxes of EUR 9 million in 2002, compared with a loss before taxes of EUR 233 million in 2001. This development is mainly attributable to the increase in revenues, which had a positive impact on income before taxes despite increased depreciation and amortization and the increase in net interest expense in the period under review.

The assets of the T-Online segment consist mainly of intangible assets, which relates to the capitalization of goodwill. The increase in investments in segment assets relates mainly to the acquisition of the shareholding in Bild.T-Online AG, recorded under financial assets. The liabilities of the segment are at approximately the same level as in the previous year and consist mainly of liabilities to subsidiaries.

**Other**

Other includes all Group units which cannot be allocated to an individual segment. These include the Deutsche Telekom Group headquarters, as well as the subsidiaries and shared services assigned to it, such as real estate, billing services, fleet management and the newly established Personnel Service Agency (PSA), as well as various competence centers and other subsidiaries, associated and related companies of the Group. The real estate area was restructured in 2002. Furthermore, fleet management was established as a separate company, DeTeFleetServices GmbH, in the third quarter of 2002 for the development, provision and operation of corporate fleet solutions. The business of the Central and Eastern European telecommunications companies MATAV, Slovenske Telekomunikacije and Hrvatske telekomunikacije, previously assigned to the segment

Other in the 2001 financial statements, have been re-assigned to T-Com since January 1, 2002. The figures for the previous year have been adjusted to reflect this change in structure.

The net revenue of the segment Other, EUR 573 million, consists to a considerable extent of the revenues generated by the real estate companies. The decrease compared with the previous year is attributable to the deconsolidation of DeTeSat.

The decrease of EUR 643 million in revenue from business with other segments is mainly the result of lower intra-Group revenues. On the one hand, cost savings in the area of customer billing were passed on to the divisions, on the other hand, use of real estate services by the divisions was lower than in the previous year.

The decrease in depreciation and amortization is mainly attributable to the nonscheduled depreciation on real estate in the previous year, for which there are no comparable measures in 2002. The increase of EUR 1,408 million in net interest expense is due to a considerable extent to the conversion of receivables from T-Mobile International AG into shareholders' equity in 2001. The interest income generated by this measure is offset by a corresponding decrease in interest expense in the segment T-Mobile. Furthermore, the loss related to associated and related companies increased from EUR 375 million in 2001 to EUR 1,093 million in 2002. This



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development is mainly attributable to the valuation adjustment of EUR 613 million on the shares held in France Telecom and a valuation adjustment on investments in noncurrent securities of EUR 384 million.

The development of results continued to be influenced to a considerable extent by the high level of proceeds from the sale of the Sprint FON and PCS shares in the previous year, for which there are no comparable proceeds in the year under review. The increase in other operating expenses, which relates mainly to expenses associated with the sale of receivables and expenses relating to the standardization of the names

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of individual mobile communications operators, also contributed to the decline of the result before taxes to a loss of EUR 4,454 million in the 2002 financial year.

The decrease in segment assets to EUR 12,978 million is attributable in particular to the decrease in property, plant and equipment and financial assets. This was the result in particular of the sale of a first tranche of real estate assets and the sale of the shares held in France Telecom. The considerable decrease in liabilities in the period under review is mainly attributable to the reduction of debt.

**Reconciliation**

The items included in the reconciliation column relate mainly to consolidation measures. The reconciliation does not include any additional items for the period under review. In 2001, this included a final nonscheduled write-down in the form of a general valuation adjustment amounting to EUR 466 million, made as part of Deutsche Telekom's strategy to separate itself more quickly from a considerable proportion of its real estate portfolio. This valuation adjustment, which does not affect the operational segments, has no effect on the internal operation of the segments.

**(36) Information on the Board of Management and the Supervisory Board of Deutsche Telekom AG**

In the 2002 financial year, the Supervisory Board was paid remuneration and meeting attendance fees of EUR 555,702. Members of the Supervisory Board do not receive performance-related compensation.

Board of Management members receive fixed and variable, performance-based remuneration and the Presiding Committee of the Supervisory Board may decide to extend stock options from the applicable Deutsche Telekom AG Stock Option Plan to members of the Board of Management. The ratio of fixed and variable remuneration in the past financial year was approximately 60%: 40%. The intention is to attach an equal weighting to both elements of Board of Management remuneration. Performance-based remuneration is determined on the basis of the targets agreed between the Supervisory Board Presiding Committee and the Board of Management members and the extent to which these targets are achieved. This is assessed by the Presiding Committee on closure of the financial year.

Provided that the 2002 financial statements of Deutsche Telekom AG are approved in their current form:

The remuneration of the Board of Management will amount to EUR 14,478,818.28 for the past financial year. No stock options were granted to the members of the Board of Management in the 2002 financial year. Remuneration paid to former members of the Board of Management and their surviving dependents totaled EUR 26,437,713.11. The figure reported here increased considerably compared with the previous year on account of the reorientation of the Group Board of Management and the resulting personnel changes on the Board of Management, including the position of Chairman, as described in the Supervisory Board's report to the 2003 shareholders' meeting. The Company published the amounts to be expensed in conjunction with the restructuring of the Board of Management on November 28, 2002. The accrual set up for ongoing pensions and pension entitlements for this group of persons amounted to EUR 38,089,883. Pension obligations to such persons for which no accrual had to be established amounted to EUR 3,368,531.

The members of the Board of Management and former members of the Board of Management, respectively, have not received any loans from the Company.

**(37) Proposal for Appropriation of Net Income (Loss) of Deutsche Telekom AG**

The statement of operations of Deutsche Telekom AG reflects a net loss of EUR 3,001 million. Including the unappropriated net income of EUR 23 million carried forward from 2001 and the withdrawal of EUR 2,978 million from retained earnings in 2002, the cumulative unappropriated net income is nil.

**(38) Declaration of Compliance with the German Corporate Governance Code in Accordance with § 161 of the AktG**

In accordance with § 161 of the AktG, the Board of Management and the Supervisory Board submitted the mandatory declaration of compliance, and made it available to shareholders on Deutsche Telekom's site on the Internet on December 19, 2002.

The declaration of compliance of the publicly traded subsidiary T-Online International AG was made accessible for shareholders on T-Online International AG's Internet site.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(39) Fair Value**

The following table presents fair values and carrying amounts for certain account balances.

	As of December 31, 2002		As of December 31, 2001	
	Fair value	Net carrying amount	Fair value	Net carrying amount
(millions of )				
<b>Assets</b>				
Other investments in related companies	1,169	1,021	2,024	1,895
Other long-term loans	109	107	534	534
Other investments in noncurrent securities	238	238	880	879
Receivables	6,258	6,258	6,826	6,826
Liquid assets	1,905	1,905	2,868	2,868
Other investments in marketable securities	413	413	702	702
<b>Liabilities</b>				
Bonds and debentures	60,144	56,752	60,568	58,301
Liabilities to banks	6,368	6,292	8,730	8,730
Other liabilities	10,541	10,541	12,020	12,020
Derivative financial instruments <sup>(1)</sup>				
Interest rate swaps	67	(230)	532	(34)
Interest rate caps / collars purchased	0	0	(3)	(1)
Cross currency interest rate swaps sold	(488)	(190)	(152)	270
Foreign currency forward contracts	12	28	(250)	(81)

(1) Amounts in parentheses represent liabilities.

Fair values were determined as follows:

The fair value of other investments in noncurrent securities and in marketable securities is based on quoted market prices for those instruments or similar instruments. The net carrying amount of other investments in marketable securities is adjusted to market value where market value is less than the original investment. The net carrying amounts of trade accounts receivable approximate their fair values, due to the short period to maturity. The net carrying amounts of liquid assets also reflect reasonable estimates of fair value due to the relatively short period to maturity of the instruments.

The fair value of debt which is publicly traded, primarily bonds and debentures, is estimated based on quoted market prices at year end. The fair value of liabilities to banks is estimated using discounted cash flows. The fair value of off-balance sheet financial instruments generally reflects the estimated amount the Company would receive or pay to terminate the contracts at the reporting date, thereby taking into account the current unrealized gains and losses of open contracts. The estimated fair values of derivatives used to hedge or modify the Company's risk will vary substantially with future changes in interest rates or with fluctuations in foreign exchange rates. These changes in fair values should not be viewed in isolation, but rather in relation to changes in the values of the hedged item in the transaction.

At December 31, 2002 and 2001, the carrying values of investments in other related companies were EUR 1,021 million and EUR 1,895 million, of which the carrying value of companies whose shares are publicly traded was EUR 752 million and EUR 734 million, respectively. The fair values of investments in other related companies that are not publicly traded are not practicably determinable.



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(40) Reconciliation to U.S. GAAP**

The consolidated financial statements of Deutsche Telekom AG have been prepared in accordance with German GAAP, which differs in certain respects from generally accepted accounting principles in the United States (U.S. GAAP). Application of U.S. GAAP would have affected the results of operations for each of the years in the three-year period ended December 31, 2002 and the balance sheets as of December 31, 2002 and 2001 to the extent described below.

**Reconciliation of Net Income (Loss) from German GAAP to U.S. GAAP:**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Net income (loss) as reported in the consolidated financial statements under German GAAP	(24,587)	(3,454)	5,926
U.S. GAAP reconciling adjustments			
Differences in long-lived assets:			
Differences in fixed assets (a)	422	401	2,792
Mobile communications licenses (b)	4,519	2,098	865
Internally developed software (c)	40	166	95
Goodwill and asset differences (d)	(2,292)	(285)	(97)
Write-down of tradenames (e)	(1,038)	1,040	
Effects of dilution gains (f)	(260)	(396)	1,741
Derivatives and related foreign exchange differences (h)	(48)	(31)	(146)
Implementation of SFAS 133 (h)		370	
Accruals for personnel restructuring (i)	294	10	(125)
Deferral of gains on divestitures (j)	321	27	(348)
Deferred income (k)	(97)	(168)	48
Implementation of SAB 101, cumulative to December 31, 1999 (k)			(869)
Capital raising and financing costs (l)			120
Asset-backed securitizations (m)	175	(71)	
Investments in equity investees (n)	345	(182)	62
Effects of full consolidation of debis, net of tax (o)	(28)	(294)	(116)
Other differences (p)	239	226	(197)
Income taxes (q)	(103)	1,066	(482)
Net income (loss) in accordance with U.S. GAAP	<u>(22,098)</u>	<u>523</u>	<u>9,269</u>
Income (loss) before cumulative effect of changes in accounting principle	(22,098)	297	9,706
Cumulative effect of changes in accounting principles- implementation of SFAS No. 133 in 2001 and SAB 101 in 2000, net of tax		226	(437)
Net income (loss) in accordance with U.S. GAAP	<u>(22,098)</u>	<u>523</u>	<u>9,269</u>

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	<u>2002</u>	<u>2001</u>	<u>2000</u>
Basic and diluted earnings (loss) per share/ADS under U.S. GAAP (in \$)			
Earnings (loss) per share/ADS before implementation of SFAS No. 133/SAB 101	(5.31)	0.08	3.21
Cumulative effect from implementation of SFAS No. 133/SAB 101		0.06	(0.15)
	<u>          </u>	<u>          </u>	<u>          </u>
Total basic and diluted earnings (loss) per share/ADS in accordance with U.S. GAAP	(5.31)	0.14	3.06
	<u>          </u>	<u>          </u>	<u>          </u>
Weighted average shares outstanding basic (in millions)	4,159	3,676	3,030
Weighted average shares outstanding diluted (in millions)	4,159	3,689	3,030

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Reconciliation of Shareholders' Equity from German GAAP to U.S. GAAP:**

	As of December 31,	
	2002	2001
	(millions of \$)	
<b>Shareholders' equity as reported in the consolidated financial statements under German GAAP</b>	35,416	66,301
<b>U.S. GAAP reconciling adjustments</b>		
Differences in long-lived assets:		
Differences in fixed assets (a)	3,579	3,193
Mobile communications licenses (b)	7,108	2,963
Internally developed software (c)	502	438
Goodwill and asset differences (d)	(470)	2,672
Write-down of tradenames (e)		1,062
Effects of dilution gains (f)	1,085	1,345
Unrealized gains on marketable securities (g)	166	580
Derivatives and related foreign exchange differences (h)	82	29
Implementation of SFAS 133 (h)		338
Accruals for personnel restructuring (i)	316	22
Deferral of gains on divestitures (j)		(321)
Deferred income (k)	(1,243)	(1,144)
Asset-backed securitizations (m)	103	(71)
Investments in equity investees (n)	(43)	(117)
Effects of full consolidation of debis, net of tax (o)		(410)
Other differences (p)	52	82
Income taxes (q)	2,686	2,049
Minority interest (r)	(3,988)	(5,307)
	<u>45,351</u>	<u>73,704</u>
<b>Shareholders' equity in accordance with U.S. GAAP</b>		



**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Consolidated Statements of Shareholders Equity in Accordance with U.S. GAAP****For the years ended December 31, 2002, 2001 and 2000****(Amounts in millions of \$)**

	Accumulated Other Comprehensive Income (Loss)							Total	
	Capital Stock <sup>(5)</sup>	Additional paid-in capital	Retained earnings	Difference from currency translation	Available- for-sale securities	Derivative instruments	Minimum pension liability		Treasury stock
Balance, December 31, 1999	7,756	23,881	5,775	(364)	577			(14)	37,611
Net income			9,269						9,269
Unrealized net gains (losses) on marketable securities <sup>(1)</sup>					1,312				1,312
Reclassification of net realized (gains) losses included in net income <sup>(2)</sup>					146				146
<b>Total comprehensive income</b>									<b>10,727</b>
Dividends for 1999 <sup>(6)</sup>			(1,874)						(1,874)
Proceeds from share offering		125							125
Transfer to reserve for treasury stock								7	7
Other			(8)						(8)
Difference from currency translation				(480)					(480)
<b>Balance, December 31, 2000</b>	<b>7,756</b>	<b>24,006</b>	<b>13,162</b>	<b>(844)</b>	<b>2,035</b>			<b>(7)</b>	<b>46,108</b>
Net income			523						523
Unrealized net gains (losses) on marketable securities <sup>(1)</sup>					67				67
Reclassification of net realized (gains) losses included in net income <sup>(2)</sup>					(1,971)				(1,971)
Additional minimum pension liability <sup>(3)</sup>								(158)	(158)
Net gains (losses) on derivatives <sup>(4)</sup>						64			64
Difference from currency translation				(762)					(762)
<b>Total comprehensive (loss)</b>									<b>(2,237)</b>
Dividends for 2000 <sup>(6)</sup>			(1,877)						(1,877)
Shares issued for acquisition of	2,990	28,624							31,614

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T-Mobile USA and Powertel									
Amortization of deferred stock-based compensation and tax benefit of exercised stock options		96							96
Balance, December 31, 2001	10,746	52,726	11,808	(1,606)	131	64	(158)	(7)	73,704
Net loss			(22,098)						(22,098)
Unrealized net gains (losses) on marketable securities <sup>(1)</sup>					(380)				(380)
Additional minimum pension liability <sup>(3)</sup>							(128)		(128)
Net gains (losses) on derivatives <sup>(4)</sup>						(145)			(145)
Difference from currency translation				(4,176)					(4,176)
Total comprehensive (loss)									(26,927)
Dividends for 2001 <sup>(6)</sup>			(1,539)						(1,539)
Shares issued for acquisitions		83							83
Amortization of deferred stock-based compensation		30							30
Balance, December 31, 2002	10,746	52,839	(11,829)	(5,782)	(249)	(81)	(286)	(7)	45,351

(1) Unrealized net gains (losses) on marketable securities, net of tax (EUR 25 million in 2002, EUR 0 million in 2001 and 2000)

(2) Reclassification of realized gain (losses) included in net income, net of tax (EUR 0 million in 2002, EUR 19 million in 2001 and EUR 154 million in 2000)

(3) Additional minimum pension liability net of tax (EUR 82 million in 2002, EUR 101 million in 2001)

(4) Net gains (losses) on derivatives net of tax (EUR 30 million in 2002, EUR 10 million in 2001)

(5) Number of shares outstanding (in millions) are 3,024, 3,027, 4,156 and 4,153 at December 31, 1999, 2000, 2001 and 2002, respectively. The outstanding amounts differ from the amounts determined under German GAAP in 2001 and 2002 due to the treatment of shares placed in a trust as part of the acquisition of T-Mobile USA and Powertel.

(6) The dividends per share/ADS (in ¢) for 2002, 2001 and 2000 were 0.0 (proposed), 0.37, and 0.62, respectively. Dividends per share are presented on the basis of the year in respect of which they are declared, not the year in which they are paid.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(a) Differences in Fixed Assets**

The following table presents a summary of the main U.S. GAAP adjustments to equity discussed in this note:

	As of December 31,	
	2002	2001
	(millions of )	
(i) Valuation of fixed assets	3,060	3,046
(ii) Sale and leaseback transactions	(55)	(42)
(iii) ISDN boxes	102	153
(iv) Write-down of submarine cable and indefeasible-rights-of-use	249	
(v) Capitalization of interest and other	223	36
	<b>3,579</b>	<b>3,193</b>

(i) Under German GAAP, the Company previously wrote-down fixed assets primarily relating to its real estate holdings. These write-downs were not required under U.S. GAAP for real estate classified as held and used. This resulted in a difference of approximately EUR 2,833 million and EUR 3,046 million in the carrying basis of land and buildings between U.S. GAAP and German GAAP at December 31, 2002 and 2001, respectively. In addition, the Company wrote-down EUR 227 million relating to the carrying value of certain fixed assets, on the basis of the prudence principle under German GAAP during 2002. Under U.S. GAAP, this writedown did not meet the impairment criteria under SFAS No. 144, and, therefore was included in the reconciliation. These differences in valuation result in higher depreciation expense to be recorded under U.S. GAAP than under German GAAP. In addition, these differences will affect the gains or losses to be recognized upon sale of the real estate, to the extent that these differences in carrying values relate to the assets sold.

(ii) During 2002 and 2001 the Company entered into a series of sale and leaseback transactions primarily underlying its real estate holdings. These leasebacks qualified as off-balance-sheet leases under German GAAP. However, these transactions have been accounted for as financings under U.S. GAAP due to the Company's continuing involvement. The cumulative proceeds from the sales in 2002 and 2001 of EUR 1,664 million are recorded as liabilities, and the net book value of the sold assets of EUR 1,554 million remain recorded as assets. Additionally, approximately EUR 55 million in financing fees were capitalized as other assets related to the transactions, and are amortized over the 18-year life of the contracts. The future payments under German GAAP are included as minimum lease payments under operating leases in note (13) to the consolidated financial statements.

(iii) The Company historically capitalized ISDN boxes relating to digital telephony services under both German and U.S. GAAP. In 2000, the acquisition costs for new ISDN boxes no longer exceeded the Company's minimum capitalization threshold under German GAAP and were expensed when acquired. As new assets no longer met the criteria for capitalization, the Company also expensed EUR 204 million in 2000 relating to the remaining book values of the assets previously capitalized. Under U.S. GAAP, the fact that new equipment purchases do not meet the criteria for capitalization does not result in the write-off of equipment previously capitalized in accordance with the Company's accounting policy. Accordingly, this write-off was not recorded and the costs are capitalized and depreciated under U.S. GAAP. The remaining net book value was EUR 102 million and EUR 153 million at December 31, 2002 and 2001, respectively.

(iv) During 2002, the Company recorded an EUR 249 million write-down in the values of certain of its indefeasible-rights of-use (IRUs) and submarine cables, for German GAAP purposes, due to declines in market prices for supply. This write down was not required under US GAAP, since the book values of the IRUs and cables were components of a larger cash generating unit with identifiable cash flows sufficient to recover the assets.

(v) Under German GAAP, the capitalization of interest related to fixed assets under construction is based on the allocated interest expense given the financial structure of the Company. Under U.S. GAAP, the capitalization of interest related to fixed assets under construction does not take into account the Company's financial structure, but capitalizes the interest expense related to interest on borrowings used for construction costs during the construction period. As a result, the Company capitalized an additional EUR 156 million and EUR 39 million of interest expense related to assets under construction for U.S. GAAP, in 2002 and 2001,

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respectively. In addition, site rental expense during the construction period is recorded as a paid expense under German GAAP, but under U.S. GAAP the cost is capitalized as part of the constructed asset. As a result, an additional EUR 53 million was capitalized as part of the cost of the assets in 2002.

**(b) Mobile Communications Licenses**

Under German GAAP, the costs of the UMTS licenses purchased in the United Kingdom, Germany and Austria in 2000, licenses obtained in the acquisition of T-Mobile USA and Powertel, and the UMTS license obtained in the acquisition of Ben in 2002 are amortized as scheduled from the time of acquisition over the expected period of usage. The interest on borrowings made to finance the acquisitions of these licenses is recognized immediately as an expense. Under U.S. GAAP, amortization of the UMTS licenses commences from the beginning of the economic use of the licenses, considered to be the start of operation of the networks, over the expected period of usage. Mobile licenses used in the U.S. have been determined to be intangible assets with indefinite useful lives under SFAS No. 142 and, accordingly, are not amortized. On a combined basis this resulted in a decrease in amortization expense of EUR 1,692 million, EUR 863 million and EUR 377 million in 2002, 2001 and 2000, respectively. The interest accumulated on borrowings through the start of network operation represents part of the acquisition costs under U.S. GAAP, resulted in a decrease in interest expense of EUR 1.2 billion, EUR 1.2 billion and EUR 488 million in 2002, 2001 and 2000, respectively. Under German GAAP, nonscheduled amortization amounting to EUR 2,165 million was recorded in 2002 relating to the UMTS license in the U.K. Under U.S. GAAP, the nonscheduled amortization did not meet the criteria for an impairment charge under SFAS No. 144, and therefore no impairment charge was recorded. Under German GAAP, nonscheduled amortization amounting to EUR 9,384 million was recorded to reduce the licenses in the U.S. to their fair value as of September 30, 2002. Under U.S. GAAP, the licenses are subject to the requirements of SFAS No. 142, and the value was determined to be impaired during the annual impairment test performed as of September 30, 2002. As a result, an impairment charge amounting to EUR 9,923 million was recognized under U.S. GAAP, a difference of EUR 539 million when compared with German GAAP.

**(c) Internally Developed Software**

Under U.S. GAAP, in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Company capitalizes certain internal and external expenses incurred during the project development stage of computer software for internal use. These assets are being amortized over their estimated useful lives of four years. Under German GAAP, these costs are expensed as incurred.

**(d) Goodwill and Asset Differences**

Differences exist between German and U.S. GAAP in the valuation of assets and liabilities of acquired businesses due to valuation of shares and stock options issued, valuation of underlying assets and liabilities (including deferred taxes), dates used to calculate consideration paid, as well as the date at which an acquisition is considered completed. The acquisitions resulting in the majority of the differences between German GAAP and U.S. GAAP are discussed following the tables below.

On January 1, 2002, the Company implemented SFAS No. 142. Upon its adoption, goodwill was no longer amortized under U.S. GAAP. The standard requires the assessment of the carrying value of goodwill and other intangible assets with indefinite useful lives for impairment annually or when indicators of impairment exist. The Company will perform the annual assessment of impairment as of the end of the third quarter of each year. Under SFAS No. 142, goodwill and other intangible assets with indefinite useful lives are deemed to be impaired if the carrying value of the asset exceeds its fair value. See note (42) for additional information regarding the Company's accounting for goodwill and other intangible assets.

The following table quantifies the differences in amortization expense for goodwill and intangible assets, with indefinite lives, as well as depreciation expense on fixed assets related to these assets for the years ended December 31, 2002, 2001, and 2000. The table also includes the differences between nonscheduled amortization recognized under German GAAP and the effects of impairment charges of goodwill and intangibles recognized

under U.S. GAAP:

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****U.S. GAAP Reconciling Adjustments to the Statement of Operations**

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
U.S. GAAP adjustments to German GAAP, expense (increase) decrease			
Goodwill amortization	3,128	466	326
Reversal of nonscheduled amortization of goodwill under German GAAP	9,865		
Goodwill impairment charges under U.S. GAAP	(14,567)		
Intangible asset amortization expense	(692)	(727)	(413)
Fixed asset depreciation expense	(26)	(24)	(10)
Net effect	(2,292)	(285)	(97)

The following table quantifies the differences between U.S. GAAP and German GAAP for goodwill, intangible assets, and fixed assets resulting from the Company's acquisitions.

**U.S. GAAP Reconciling Adjustments to Shareholders' Equity**

	As of December 31,	
	2002	2001
	(millions of )	
U.S. GAAP adjustments to German GAAP carrying values, increase (decrease)		
Goodwill, net book value	(3,258)	(1,784)
Intangible assets	4,130	5,422
Intangible asset accumulated amortization	(1,496)	(1,140)
Fixed assets	214	208
Fixed asset accumulated depreciation	(60)	(34)
Net effect	(470)	2,672

In 2001, the Company acquired T-Mobile USA and Powertel. The Powertel acquisition was a 100% stock acquisition with a predetermined fixed stock conversion rate that was not subject to adjustment. Under APB 16, the acquirer is required to use the stock price based on the date of the acquisition agreement to determine the acquisition price. This resulted in an increase in the U.S. GAAP purchase price, as compared to German GAAP. Based on a third party valuation, the purchase price was allocated to certain intangible assets as well as differences in deferred taxes which reduced the net effect on goodwill related to the purchase price differences. The purchase price and purchase price allocation differences related to the T-Mobile USA and Powertel acquisitions resulted in increases in goodwill of EUR 888 million and intangibles of EUR 1.1 billion under U.S. GAAP as compared to German GAAP as of the date of acquisition.

In 2000, the Company completed its purchase price allocation for T-Mobile UK (formerly One 2 One). The differences between German GAAP and U.S. GAAP primarily relate to the allocations made from goodwill to intangible assets for U.S. GAAP purposes, mainly related to licenses, tradename and customer lists. The allocation from goodwill to intangible assets was offset by the applicable deferred taxes under U.S. GAAP. See note (40 o) for a discussion of goodwill and asset differences relating to the acquisition of debis.

*(e) Write-down of Tradenames*

At the end of 2001, the Company made the decision to re-brand its foreign mobile subsidiaries operating in the T-Mobile business segment to a common T-Mobile name by the end of 2002. For German GAAP purposes, this resulted in an immediate write-down of the respective portion of goodwill attributable to tradenames for the projected net book value on December 31, 2002, assuming normal amortization in 2002. This adjustment resulted in a net book value at the end of 2001 equivalent to one-year's normal amortization. For U.S. GAAP purposes, the decision was considered a triggering event resulting in an impairment assessment under SFAS No. 121. Based on this assessment, no impairment existed, but the assets were considered to be in use through the end of 2002. Accordingly, the write-down recorded under German GAAP

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was reversed. However, under U.S. GAAP, the remaining useful lives were shortened, with the remaining carrying amounts completely amortized by December 31, 2002 under both German GAAP and U.S. GAAP.

**(f) Effects of Dilution Gains**

In 2000, T-Online, comdirect bank AG ( comdirect ) and OJSC Mobile TeleSystems ( MTS ) entered into transactions in which their shares were either sold for cash or exchanged as part of a purchase business combination. As a result of these transactions, the Company's ownership interest in the subsidiary or affiliate is reduced, resulting in a dilution gain. For German GAAP, the Company recognized dilution gains resulting from cash sales of subsidiary or affiliate shares as a credit to income. However, the Company does not recognize changes in interest transactions when cash proceeds are not received, unless a portion of those shares are sold at a later time to a third party for cash. Under U.S. GAAP, all cash and noncash equity transactions of subsidiaries or affiliates, including those related to purchase business combinations, are reflected as dilution gains. The following transactions generated dilution gains in 2000:

## Cash transactions:

In April 2000, T-Online issued 114,100,000 ordinary shares in an initial public offering ( IPO ) at EUR 27 per share for cash consideration totaling EUR 3,080 million. This reduced the Company's ownership in T-Online from 100% to 89.76%, resulting in a dilution gain of EUR 2,657 million under both German and U.S. GAAP.

In June 2000, MTS, a Russian mobile telephone company, issued 345,244,080 shares for cash consideration totaling EUR 364 million in an IPO. This reduced the Company's ownership percentage in MTS from 44.1% to 36.2%, resulting in a dilution gain of EUR 111 million, under both German and U.S. GAAP.

In June 2000, comdirect, an on-line bank, issued 20,500,000 shares at EUR 31 per share for cash consideration totaling EUR 636 million in an IPO. This reduced T-Online's ownership percentage in comdirect from 25% to 21.35%, resulting in a dilution gain of EUR 119 million. For U.S. GAAP the dilution gain is EUR 57 million lower because the equity investment balance was higher for U.S. GAAP at the date of the IPO.

## Non-cash transactions:

In April 2000, T-Online acquired all of the shares outstanding of Club Internet, a French Internet provider, in exchange for 69,633,116 T-Online ordinary shares valued at EUR 27 per share. Consideration totaled EUR 1,880 million and decreased the Company's ownership percentage in T-Online from 89.76% to 84.48%. Under U.S. GAAP, the dilution gain of EUR 1,355 million has been recognized in 2000 as income with a corresponding increase to goodwill.

In April 2000, T-Online acquired a 25% interest in comdirect in exchange for 24,875,189 T-Online ordinary shares valued at EUR 27 per share. Consideration totaled EUR 671 million and decreased the Company's ownership percentage in T-Online from 84.48% to 82.74%. Under U.S. GAAP, the dilution gain of EUR 391 million has been recognized as income in 2000 with a corresponding increase to goodwill.

In October 2000, T-Online acquired all of the outstanding shares of ya.com, a Spanish Internet service provider, in exchange for 12,387,280 T-Online ordinary shares valued at EUR 32.42 per share. Consideration totaled EUR 402 million and decreased the Company's ownership percentage in T-Online from 82.87% to 81.71%. Under U.S. GAAP, the dilution gain of EUR 222 million has been recognized as income in 2000 with a corresponding increase in goodwill.

Dilution gains related to sales of shares for cash totaled EUR 2,887 million in 2000 and have been recorded as income for German GAAP. For U.S. GAAP, this amount was EUR 57 million lower due to the different carrying basis in comdirect. Dilution gains related to purchase business combinations totaling EUR 1,968 million have been recorded as income for U.S. GAAP purposes but not recognized for

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German GAAP purposes. For both German and U.S. GAAP, no deferred taxes have been provided as under the currently enacted German tax law the above transactions did not give rise to any taxable event.

Amortization of the additional goodwill totaled EUR 250 million and EUR 170 million in 2001 and 2000, respectively, based on goodwill lives ranging from 7 to 15 years. No amortization of the additional

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goodwill was recorded in 2002 because of the implementation of SFAS No. 142. In 2001 and 2002, as a result of impairment testing, an impairment charge was recorded to reduce the carrying value of the investment in comdirect to fair value. As the carrying basis for comdirect under U.S. GAAP exceeded the carrying basis under German GAAP due to the recognition of the dilution gains, additional write-downs of approximately EUR 145 million and EUR 146 million in 2002 and 2001, respectively, were recorded under U.S. GAAP. The charge was taken as a result of the continued losses of comdirect and the decline in the market value of the stock of comdirect. The impairment charge was calculated by comparing the book value of the investment in comdirect including goodwill with the market value of the shares owned.

In 2002, the Company recognized a EUR 116 million larger gain for German GAAP on the sale of 9.81% of the shares in T-Online International AG. This difference results from dilution gains which were previously recognized for U.S. GAAP only.

***(g) Unrealized Gains on Marketable Securities***

Under German GAAP, investments in marketable debt and equity securities (including certain securities classified as other investments) are generally carried at historical cost. Under U.S. GAAP, investments in marketable debt and equity securities, other than investments accounted for by the equity method, are categorized as either trading, available for sale, or held to maturity. Securities classified as trading or available for sale are reported at fair value at the balance sheet date and held to maturity securities are reported at historical cost. Unrealized gains and losses on trading securities are recorded in net income while unrealized gains and losses on securities categorized as available for sale are recorded, net of income tax, in shareholders equity as a component of accumulated other comprehensive income.

***(h) Derivatives and Related Foreign Exchange Differences***

Under German GAAP, derivatives are recorded at cost, with a provision established if losses due to changes in fair values have occurred. However, when a derivative is specified as a hedge for a particular risk exposure, a provision is established for the net amount of the unrealized losses due to changes in fair values on the combined derivative and the hedged exposure.

Under U.S. GAAP, all freestanding derivatives and all bifurcated embedded derivatives are recognized as either assets or liabilities and measured at fair value. Changes in the fair value of derivative instruments are reported in earnings or other comprehensive income depending on the derivative's hedge designation, and on whether the hedge is highly effective. See additional discussion related to derivatives under German GAAP in note (34) and under U.S. GAAP in note (43 d).

***(i) Accruals for Personnel Restructuring***

Under German GAAP, the Company established provisions for the total costs expected to be incurred resulting from workforce reductions when those costs can be estimated. Under U.S. GAAP, the costs associated with voluntary workforce reductions are recognized in the period of acceptance by the employee of the termination offer and costs associated with involuntary workforce reductions only when all requirements to establish a restructuring accrual are fulfilled under SEC Staff Accounting Bulletin 100, Restructuring and Impairment Charges, and EITF issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs included in a Restructuring).

***(j) Deferral of Gains on Divestitures***

During 2000, the Company sold its interests in the broadband cable operations located in the North Rhine-Westphalia and Hesse regions in two separate transactions for a combination of cash, deferred payment notes, preference interest and equity interests in the buyers, for an aggregate sales price consideration of EUR 4,542 million.

During 2001, the Company sold its interest in the broadband cable operations located in Baden Wuerttemberg for a combination of cash, deferred payment note and equity interest in the buyer for a total sales price consideration of EUR 1,320 million. Under German GAAP, full gains upon consummation of these sales were recognized. During 2001 and 2000, interest income of EUR 62 million and EUR 21 million, respectively, representing the accretion on the deferred payment notes and preference interest was recognized and EUR 389 million and EUR 73 million were recorded to write-down the deferred payment notes and

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preference interest to fair market values. In 2002, no interest income was recognized on the deferred payment notes and preference interest under German GAAP, as these amounts were not deemed collectible and a provision of EUR 321 million was established to reduce the net carrying value of the deferred payment notes and preference interest to their fair values.

For U.S. GAAP, however, due to the equity interests received in these transactions, gains were calculated to the extent deemed sold. In addition, due to the high leverage of the buyers and the uncertainty of cash flows to repay the deferred payment notes and preference interest, the Company followed the guidance in Staff Accounting Bulletin Topic 5:U, *Gain Recognition on the Sale of Business or Operating Assets to a Highly Leveraged Entity*, and deferred the amount of the gains relating to the deferred payment notes and preference interest received until collections become reasonably assured. In addition, the provisions recorded under German GAAP have been reversed, since the gains associated with the deferred payment notes and preference interest were not recognized in earnings under U.S. GAAP.

***(k) Deferred Income***

Under U.S. GAAP, the Company defers activation fees and certain other one-time charges and amortizes them over the average life of the related service period. The related direct incremental costs, up to the amount of revenues, are also deferred and subsequently amortized. Under German GAAP, the revenue and incremental direct costs are recognized immediately. All other direct costs associated relating to customer activation are expensed as incurred under both German and U.S. GAAP. The Company also has certain other contracts with differing revenue recognition methods and periods. A network sharing agreement is accounted for under German GAAP with the revenue being recognized in accordance with the economic useful life, whereas under U.S. GAAP the revenue is to be recognized over the duration of the agreement. A second type of contract relates to IRUs. Under German GAAP, the sales of sub-leasing of capacity on certain fiber optic networks are recognized immediately, whereas, under U.S. GAAP, the sales are recorded as deferred revenue and recognized in earnings over the contract term, ranging from 20 to 25 years.

***(l) Capital Raising and Financing Costs***

Under German GAAP, the costs incurred in connection with the equity share offerings are recorded as extraordinary expenses in the statement of operations. Under U.S. GAAP, the specific incremental costs directly attributable to equity share offerings are charged against equity capital.

***(m) Asset-Backed Securitizations***

In December 2001 and December 2002, the Company entered into asset-backed securitization programs for the sale of qualifying receivables at its T-Com and T-Systems divisions. Under German GAAP, the values of the receivables sold and residual interests retained are based on contractually stated values. For U.S. GAAP the transactions are based on the fair values of the receivables sold and related interests retained. See note (43 b) for additional information regarding these transactions.

Under the T-Com securitization program, the Company retains the servicing obligation related to the sold receivables, but without remuneration. No servicing liabilities has been established under German GAAP. However, for U.S. GAAP, the Company has recorded an estimated servicing liability for future costs to be incurred on the sold receivables in the amount of EUR 50.0 million.

***(n) Investments in Equity Investees***

On January 1, 2002 the Company implemented SFAS No. 142 and, as required by that standard, ceased amortizing the embedded goodwill associated with its investments in equity investees. As a result, amortization of EUR 106 million, recorded under German GAAP in 2002 was not recorded for U.S. GAAP purposes.

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The Company accounted for its investment in Ben as an equity investee until the remaining outstanding interest was acquired on September 30, 2002. Prior to September 30, 2002, the Company recorded differences between German GAAP and U.S. GAAP of approximately EUR 253 million relating to its investment in Ben. These differences consists of, among other things, a EUR 213 million write-off of the Company's share of the UMTS licenses held by Ben, that did not meet the impairment criteria for U.S. GAAP.

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In 2001, the Company restructured its equity investments in DeTeAsia, including exchanging its shares in Islacom for shares in Globe Telecom, which resulted in the recording of gains under German GAAP, as these transactions were recorded as individual transactions based on the legal contracts signed. For U.S. GAAP purposes, these transactions were recorded as primarily one transaction and accounted for as a non-monetary transaction with no gains or losses recognized. As a result, gains totaling EUR 123 million under German GAAP were recorded as a reduction of the carrying basis under U.S. GAAP. Additionally, the investment in Globe Telecom is recorded at cost under German GAAP. For U.S. GAAP this investment is accounted for as an equity investment as required by Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting Investments in Common Stock* ( APBO No. 18 ). As a result of accounting for this investment under the equity method, the Company recognized equity in earnings of EUR 18 million in 2002.

For German GAAP purposes, the investment in Telesens has been recorded at cost. Under U.S. GAAP, this investment is accounted for as an equity investment as required by APBO No. 18. As a result of accounting for this investment under the equity method, the Company recognized an EUR 62 million loss and EUR 10 million loss in 2001 and 2000, respectively.

In 2000, as a result of an initial public offering by Telesens as well as Telesens issuing shares for an acquisition, the Company's interest was diluted from 38% to 25%. Under U.S. GAAP, these transactions resulted in the Company recognizing an EUR 72 million gain. No dilution gain was recorded for German GAAP as the investment was accounted for at cost.

The remaining differences result from differences in the recognition of equity pickup on operating results which are based on U.S. GAAP rather than German GAAP.

**(o) Effects of Full Consolidation of debis, Net of Tax**

On October 20, 2000, the Company acquired a 50.1% interest in debis Systemhaus GmbH ( debis ) by purchasing newly issued shares for EUR 4.7 billion. In connection with this acquisition, the Company received a call option to acquire the 49.9% minority interest of debis held by DaimlerChrysler Services AG ( DaimlerChrysler ), and the Company granted DaimlerChrysler a put option to sell its 49.9% minority interest in debis to the Company. The exercise price for each option was EUR 4.7 billion. The put option was immediately exercisable, and the call option was to become exercisable on January 1, 2002. Under German GAAP, the Company accounted for this transaction as the acquisition of a 50.1% interest in debis, with the 49.9% interest held by DaimlerChrysler shown as minority interest within equity.

Under U.S. GAAP, the put and the call options were viewed on a combined basis and accounted for as a financing of the purchase of the minority interest by the Company. As a result, the Company reflected debis as a wholly-owned subsidiary upon consummation of the acquisition of the 50.1% interest, with the options reflected as a liability to acquire the remaining 49.9% minority interest. Net income attributable to the remaining 49.9% interest is allocated to Deutsche Telekom, rather than to the minority interest.

During March, 2002, DaimlerChrysler exercised its put option, and the Company acquired the 49.9% minority interest in debis. Under German GAAP, the Company fully consolidated debis from the date the minority interest was acquired. However, for U.S. GAAP, the payment of the put price represented the extinguishment of the purchase obligation initially recorded in 2000.

The accounting for this transaction under U.S. GAAP resulted in the following differences in net income (loss) compared to German GAAP:

For the year ended December 31,		
2002	2001	2000

	_____	_____	_____
	(millions of )		
Increase in amortization expense	(7)	(360)	(86)
Increase in financing charges	(24)	(60)	(48)
Decrease in income applicable to minority interest		94	18
Tax benefit	3	32	
	_____	_____	_____
	(28)	(294)	(116)
	_____	_____	_____

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The financing charges represent the premiums to be paid for acquiring the minority interest in excess of the initial share price paid in October 2000, and include guaranteed dividends of EUR 10 million, EUR 60 million and EUR 10 million for the years 2002, 2001 and 2000, respectively.

***(p) Other Differences***

Other differences consist of the different accounting and valuation approaches between German GAAP and U.S. GAAP that are not individually significant, including the treatment of unrealized gains on foreign currency receivables and payables that are recognized under U.S. GAAP but not under German GAAP, accruals for maintenance, and contract accounting. Under German GAAP, accruals have to be made for maintenance that is carried out within three months after the balance sheet date. Under U.S. GAAP, maintenance expenditures are reflected in the period a specific liability has been incurred. The contract accounting differences are a result of the application of the percentage of completion method under U.S. GAAP, as opposed to the completed contract method under German GAAP.

The nondeductible capitalized VAT (capitalized prior to 1996) was recorded as property, plant and equipment. German GAAP required the capitalized VAT to be depreciated and the VAT recoveries to be recorded as other operating income. Under U.S. GAAP, the capitalized VAT was treated as a long-term receivable rather than property, plant and equipment. As VAT recoveries were received, they were offset against the receivable and neither depreciation nor other operating income was recognized. Because the capitalized VAT was fully depreciated during 2001, there was no longer a difference between German GAAP and U.S. GAAP in 2002.

In 2002 and 2001, a minimum liability related to certain pension plans was recognized as an expense under German GAAP. Under U.S. GAAP, the increase to this liability amounting to EUR 210 million and EUR 259 million in 2002 and 2001, respectively, was recorded in other comprehensive income.

***(q) Income Taxes***

The determination of income tax expense under German GAAP differs from U.S. GAAP as follows:

Under U.S. GAAP, in contrast to German GAAP, deferred tax assets are recognized for the estimated future tax effects attributable to tax loss carryforwards.

Under German GAAP, deferred taxes are not recorded for temporary differences that arose during tax-free periods. Under U.S. GAAP, the estimated future tax effects related to those temporary differences are recognized.

Under German GAAP, deferred taxes have not been recognized for those temporary differences that are not expected to reverse in the foreseeable future. Under U.S. GAAP, deferred taxes are generally recognized for all temporary differences.

In addition, deferred taxes also are provided for the income tax effects of valuation differences between U.S. GAAP and German GAAP. Deferred tax assets are measured based on enacted tax law and reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Additionally, existing deferred tax assets and liabilities recognized under U.S. GAAP are adjusted when there is an enacted change of future tax rates.

Other differences between the income tax expense determined in accordance with German GAAP and U.S. GAAP result from the differences in accounting for tax estimates and contingencies in 2002 and the consolidation effects of debits which are presented net of tax.

The following table shows the differences between income tax expense determined in accordance with German GAAP and U.S. GAAP:

	For the year ended December 31,		
	2002	2001	2000
	(millions of )		
Deferred taxes from the application of U.S. GAAP	(1,831)	2,570	(561)
Deferred taxes on U.S. GAAP/German GAAP differences	1,025	(1,472)	79
Other differences	703	(32)	
	<u>          </u>	<u>          </u>	<u>          </u>
Total difference to income tax expense	(103)	1,066	(482)
	<u>          </u>	<u>          </u>	<u>          </u>

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)***(r) Minority Interest*

Under U.S. GAAP, minority interest is not included as a component within shareholders' equity.

**(41) Deferred Taxes in Accordance with U.S. GAAP:**

Deferred tax assets and liabilities arising from temporary differences and net operating losses are as follows:

	<b>As of December 31,</b>	
	<b>2002</b>	<b>2001</b>
	(millions of \$)	
Deferred tax assets in accordance with U.S. GAAP		
Current deferred tax assets		
Net operating loss carryforwards	466	280
Inventory	156	
Personnel restructuring accrual	15	
Accruals for loss contingencies	115	404
Derivatives	17	
Other	142	91
	<u>911</u>	<u>775</u>
Noncurrent deferred tax assets		
Goodwill	2,136	
Net operating loss carryforwards	7,888	6,959
Financial assets	536	435
Personnel restructuring accrual		16
Pension accruals	518	341
Civil servant health insurance accrual	429	421
Other accruals	279	223
Accrued interest	175	
Deferred income	492	381
Deferred gains on divestiture		125
Other	63	177
	<u>12,516</u>	<u>9,078</u>
<b>Deferred tax assets in accordance with U.S. GAAP</b>	<b><u>13,427</u></b>	<b><u>9,853</u></b>
Deferred tax liabilities in accordance with U.S. GAAP		
Current deferred tax liabilities		
Receivables and other assets	(79)	
Accruals and liabilities	(234)	(389)
Derivatives		(112)
	<u>(313)</u>	<u>(501)</u>

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Noncurrent deferred tax liabilities		
Intangible assets	(5,792)	(9,173)
Property, plant and equipment	(1,179)	(883)
Personnel restructuring accrual	(59)	
Bond premium	(80)	
Other	(57)	(226)
	<u>(7,167)</u>	<u>(10,282)</u>
<b>Deferred tax liabilities in accordance with U.S. GAAP</b>		
	<u>(7,480)</u>	<u>(10,783)</u>
Net current deferred tax assets	598	274
Net noncurrent deferred tax assets (liabilities)	5,349	(1,204)
Valuation allowance	(5,611)	(468)
	<u>336</u>	<u>(1,398)</u>
<b>Net deferred tax assets (liabilities) in accordance U.S. GAAP</b>		
	<u>336</u>	<u>(1,398)</u>

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As a result of the implementation of SFAS No. 142 in 2002, a number of major wireless carriers in the United States have concluded that the U.S. Federal Communications Commission ( FCC ) wireless spectrum licenses should be considered to be intangible assets with indefinite lives. Classification by Deutsche Telekom of its FCC licenses to intangible assets with indefinite lives resulted in the cessation of scheduled amortization of these licenses, effective January 1, 2002. This cessation of amortization affected the Company's assessment as to future realization of deferred tax assets for tax loss carryforwards, resulting in the establishment of a valuation allowance of approximately EUR 4.3 billion during the first quarter of 2002.

The valuation allowance recorded for deferred taxes was EUR 110 million at December 31, 2000.

The following table shows the development of deferred taxes from German GAAP to U.S. GAAP:

	As of December 31,	
	2002	2001
	(millions of )	
Net deferred taxes under German GAAP	(1,646)	(5,348)
U.S. GAAP adjustments		
Application of U.S. GAAP	6,170	8,304
U.S./German GAAP differences	(4,188)	(4,354)
	<u>336</u>	<u>(1,398)</u>
Net deferred tax assets and liabilities in accordance with U.S. GAAP	<u>336</u>	<u>(1,398)</u>

**(42) Additional Information on the Financial Statements in Accordance with U.S. GAAP****(a) Weighted Average Shares Outstanding**

	As of December 31,	
	2002	2001
	(millions of )	
Weighted average shares outstanding German GAAP	4,195	3,715
Adjustments <sup>(1)</sup>	(36)	(39)
	<u>4,159</u>	<u>3,676</u>
Weighted average shares outstanding U.S. GAAP basic	4,159	3,676
Dilutive effect of options, warrants and exchange rights <sup>(2)</sup>		13
	<u>4,159</u>	<u>3,689</u>
Weighted average shares outstanding diluted	<u>4,159</u>	<u>3,689</u>

(1)

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Under U.S. GAAP, the weighted average shares outstanding has been adjusted to eliminate shares held in a trust, which are considered issued and outstanding for German GAAP but not for U.S. GAAP.

(2) Stock options, warrants and exchange rights issued in connection with the acquisition of VoiceStream and Powertel.

For the years ended December 31, 2002 and December 31, 2000, outstanding options, warrants and exchange rights were excluded from the computation of diluted earnings (loss) per share because they were antidilutive.

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**Table of Contents****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(b) Development of Intangible Assets**

The following is a summary of the development of goodwill and other intangible assets from December 31, 2001 to December 31, 2002.

	Goodwill			Other intangible assets		
	German GAAP	Difference	U.S. GAAP	German GAAP	Difference	U.S. GAAP
	(millions of \$)			(millions of \$)		
<b>Cost</b>						
December 31, 2001	46,075	1,140	47,215(1)	43,368	8,441	51,809(1)
Additions	4,482	(2,668)	1,814	873	1,557	2,430
Disposals	(23)	(29)	(52)	(761)	(118)	(879)
Impairments	0	(14,567)	(14,567)	0	(9,946)	(9,946)
Consolidations, reclassifications and other	850	10	860	1,745	(406)	1,339
Foreign currency effects	(4,509)	684	(3,825)	(4,317)	221	(4,096)
December 31, 2002	46,875	(15,430)	31,445	40,908	(251)	40,657
<b>Accumulated Amortization</b>						
December 31, 2001	(5,478)	1,021	(4,457) <sup>(1)</sup>	(3,914)	(111)	(4,025) <sup>(1)</sup>
Scheduled amortization	(3,243)	3,243	0	(2,691)	(139)	(2,830)
Nonscheduled amortization	(9,865)	9,865	0	(11,549)	11,549	0
Disposals	23	0	23	732	119	851
Consolidations, reclassifications and other	(171)	210	39	(841)	149	(692)
Foreign currency effects	1,295	(1,033)	262	1,321	(1,035)	286
December 31, 2002	(17,439)	13,306	(4,133)	(16,942)	10,532	(6,410)
Net book value at December 31, 2001	40,597	2,161	42,758	39,454	8,330	47,784
Net book value at December 31, 2002	29,436	(2,124)	27,312	23,966	10,281	34,247

(1) Certain reclassifications have been made to conform to the current year presentation

**(c) Summary of Certain Balance Sheet Captions**

The following is a summary of certain balance sheet captions reported in the consolidated financial statements under German GAAP and in accordance with U.S. GAAP.

German GAAP December 31,	U.S. GAAP December 31,
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	Note (40)	2002	2001	2002	2001
		(millions of )		(millions of )	
Intangible assets	(b),(c), (d),(e),(f),(o)	53,402	80,051	61,559	90,542(1)
Property, plant and equipment, net	(a),(d)	53,955	58,708	59,298	62,608
Financial assets	(d),(g),(h),(j),(n),(p)	4,169	7,957	4,364	8,191
Accruals	(h),(i),(m),(p),(q)	16,097	18,427	20,612	25,663
Debt <sup>(2)</sup>	(a),(h),(p)	63,044	67,031	65,010	67,104
Deferred income	(k),(p)	723	783	2,075	1,846

(1) Certain reclassifications have been made to conform to the current year presentation

(2) Debt under US GAAP includes EUR 58 million and EUR 93 million of amortized premiums and EUR 295 million and EUR 351 million of discounts at December 31, 2002 and 2001 respectively, which under German GAAP are included in deferred income and prepaid expenses.

As permitted by Postreform II, certain property, plant and equipment on hand as of December 31, 1992 were valued at fair values rather than at historical cost less depreciation, which is required by U.S. GAAP. The Company has not been able to quantify the effect of the difference in accounting treatment because, prior



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to January 1, 1993, the predecessor did not maintain sufficiently detailed historical cost records. The fair market values recorded in the opening balance sheet of Deutsche Telekom AG at January 1, 1995.

**(43) Other Information****(a) Stock-Based Compensation**

The Company accounts for employee stock options under U.S. GAAP in accordance with Accounting Principles Board Opinion No. 25 (APBO 25), *Accounting for Stock Issued to Employees* and related interpretations, and furnishes the pro forma disclosures required under SFAS No. 123, *Accounting for Stock-Based Compensation*.

APBO 25 requires recognition of compensation expense for variable award plans (2000 Stock Option Plan of Deutsche Telekom AG and T-Online International AG) over the vesting period of such plans, based upon the then-current market values of the underlying stock. In contrast, SFAS No. 123 requires recognition of compensation expense for grants of stock options over the vesting period of such grants, based on the estimated grant-date fair values of those grants.

Under APBO 25, the 2001 stock option plans for both Deutsche Telekom AG and T-Online International AG were considered fixed plans. The 2000 plans for both companies were considered variable plans. As the exercise price of Deutsche Telekom AG's and T-Online International AG's employee stock options was higher than the market price of the underlying stock as of December 31, 2002, 2001 and 2000, no compensation expense was recognized in 2002, 2001 and 2000.

SFAS No. 123 requires presentation of pro forma information as if the Company had accounted for its employee stock based compensation under the fair value method. The alternative fair value accounting provided for under SFAS No. 123 requires use of option valuation models that were not developed for use in valuing employee stock options. The fair value of the stock options issued in conjunction with the 2002, 2001 and 2000 stock option plans were calculated at the grant date based on a Black-Scholes option pricing model for 2002 and 2001, and based on a Monte-Carlo option pricing model for 2000. The fair values were calculated in accordance with the terms of the issuance. The Monte-Carlo option pricing model was used for 2000, as the plan was considered a variable compensation plan. This model simulates multiple paths for the stock and the index between Year 2 and Year 5 (3.5) given their initial levels and takes the expected value of the payoff.

The Black-Scholes and Monte-Carlo option valuation models were developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the use of principles and assumptions that are of a highly subjective nature, including the expected stock price volatility. Because the Company's employee stock options have characteristics that are significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

At the grant dates, the underlying assumptions and the resulting fair values per option of the respective companies were as follows:

<b>Deutsche Telekom AG</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Expected dividend yield	3.60%	3.25%	1.00%
Expected stock volatility	60.0%	47.0%	44.0%
Risk-free interest rate	4.28%	4.65%	5.73%
Expected lives (in years)	4.4	5	5
Weighted average fair value per option granted during the year (in \$)	3.79	4.87	25.08

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<b>T-Online International AG</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Expected dividend yield	0%	0%	0%
Expected stock volatility	71.8%	60.0%	60.0%
Risk-free interest rate	4.333%	4.65%	5.475%
Expected lives (in years)	5	5	3.5
Weighted average fair value per option granted during the year (in \$)	4.06	3.72	13.10

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T-Mobile USA, Inc.	2002	2001
Expected dividend yield	2.60% to 3.85%	3.25%
Expected stock volatility	60.0%	47.0%
Risk-free interest rate	4.11% to 5.15%	5.50% to 5.98%
Expected lives (in years)	7.1	7.5
Weighted average fair value per option granted during the year (in USD)	23.04	35.57

MATAV	2002
Expected dividend yield	1.53%
Expected stock volatility	40.0%
Risk-free interest rate	8.31%
Expected lives (in years)	5
Weighted average fair value per option granted during the year (in HUF)	284

For purposes of pro forma disclosure, the estimated fair value of the options at the date of grant is amortized to expense over the vesting period.

On May 31, 2001, as a result of the acquisition of T-Mobile USA, Inc. and Powertel, all unvested, outstanding T-Mobile USA, Inc. and Powertel stock options were converted into options to acquire, from a trust established for the benefit of holders of T-Mobile USA, Inc. and Powertel stock options, Deutsche Telekom ADRs. Deutsche Telekom recorded deferred compensation of EUR 58 million related to unvested options due to the acquisition of T-Mobile USA, Inc. and Powertel, of which EUR 18 million and EUR 11 million were recorded as stock-based compensation expense in 2002 and for the period from June 1, 2001 through December 31, 2001, respectively.

Under the fair value method of SFAS No. 123, the Company's net income (loss) and earnings (loss) per share would have been as follows (in millions of \$):

	For the year ended December 31,		
	2002	2001	2000
Net income (loss)			
As reported	(22,098)	523	9,247
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	18	11	
Deduct: Stock-based employee compensation expense determined under fair value based accounting method, net of related tax effects	(102)	(71)	(3)
Pro forma net income (loss)	(22,182)	463	9,244
Earnings (loss) per share			
Basic earnings (loss) per share			
As reported	(5.31)	0.14	3.05

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Pro forma	(5.33)	0.13	3.05
Diluted earnings (loss) per share			
As reported	(5.31)	0.14	3.05
Pro forma	(5.33)	0.13	3.05

***(b) Asset-Backed Securitizations***

The Company and its T-Com and T-Systems divisions entered into agreements to sell, on a continuous basis, certain eligible trade accounts receivable to Qualifying Special Purpose Entities ( QSPE ). Under German GAAP, the determination of the gain or loss on the sale of receivables is based upon contractual estimates for the credit and dilution discounts. Under U.S. GAAP, in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the gain or loss on sale of receivables depends in part on the carrying amount of the transferred receivables, allocated between the receivables sold and the interests and obligations retained, based on their relative fair values as of the date of transfer. The retained interests represent future rights to residual cash balances retained by the QSPE, to be released if collection performance exceeds certain credit loss and performance thresholds. At the

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time the receivables are sold, the balances are removed from the Consolidated Balance Sheets. Costs associated with the sale of receivables, primarily related to the discount, loss on sale and other related expenses are included in program fees in the table below and classified as other expense in the consolidated Statement of Operations. Refunds of discounts are recorded when received, and classified within other income in the Consolidated Statement of Operations.

*Differences Arising from Retained Interests*

Under the T-Systems asset-backed securitization program, the retained interest is valued under German GAAP based upon the contractually specified discounts using the contractual rates in the agreement (between 7.15% to 15.5%, including credit loss rates from 3.65% to 12%). Under U.S. GAAP, the retained interest is recorded at fair value based upon historical performance. The difference between the contract value under German GAAP and the fair value under U.S. GAAP results in an increase of the value of the retained interest (and a related gain on sale) of EUR 20.4 million in 2002 for US GAAP.

Under the T-Com asset-backed securitization program, the retained interest is valued under German GAAP based upon the contractually specified discounts using the contractual rates in the agreement (6.5%, including a 3.5% credit loss rate). The difference between the contract value under German GAAP and the fair value under U.S. GAAP results in an increase in the value of the retained interest (and a related gain) of EUR 133 million in 2002, and a reduction in value of the retained interest (and a related loss on sale) of EUR 21.0 million in 2001.

*Summary of Significant Cash Flows*

The table below summarizes certain cash flows received from and paid to securitization trusts under the T-Com and T-Systems asset-backed securitizations:

	<b>For the year ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
	(millions of )	
Proceeds from sales of receivables to QSPE	16,031	1,384
Proceeds from retained interests	655	
Proceeds from collections made on behalf of QSPE	18,097	1,456
Repayment to QSPE of collections made on its behalf	(16,969)	
Program fees paid to the QSPE	(57)	

Sales of receivables resulted in a loss of approximately EUR 280 million and EUR 79 million in 2002 and 2001, respectively, which is calculated as the difference between the face value and contract value of the receivables.

*(c) Equity Method Investments*

Deutsche Telekom has numerous investments, ranging from 20% to 50%, in companies that operate in similar lines of business. Deutsche Telekom's investments in equity method affiliates amounted to EUR 2.6 billion and EUR 4.1 billion at December 31, 2002 and December 2001, respectively. Deutsche Telekom's equity in net earnings (losses) of its equity method affiliates under U.S. GAAP was EUR (85) million, EUR (653) million and EUR 2.7 billion for the years 2002, 2001 and 2000, respectively.

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Deutsche Telekom received dividends based on its equity interests in these companies of EUR 23 million, EUR 2.8 billion and EUR 29 million for the years 2002, 2001 and 2000, respectively.

The schedules below present summarized statements of operations and balance sheet information for the significant investments that were accounted for under the equity method in 2001. Comparable information for 2000 is also presented for the statement of operations. Summarized financial information is not presented for

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2002, since the Company's equity investments were not deemed significant in 2002 either individually or in the aggregate.

**Statements of Operations**

For the year ended December 31, 2001

	MTS	PTC	Ben	Virgin Mobile	Telesens	comdirect	Other Equity Investments	Total Equity Investments
	(millions of \$)							
Net revenue	926	1,187	448	264	82	236	1,422	4,565
Total expenses	(561)	(1,044)	(633)	(367)	(304)	(387)	(1,561)	(4,857)
Income (loss) before income taxes and minority interest	365	143	(185)	(103)	(222)	(151)	(139)	(292)
Income taxes	(108)	(9)			(23)	(10)	(80)	(230)
Minority interest	9							9
Income before effect of change in accounting principle and extraordinary gains (losses)	266	134	(185)	(103)	(245)	(161)	(219)	(513)
Cumulative effect of change in accounting principle, net of income taxes	(20)	(1)		(1)				(22)
Extraordinary gains (losses), net of income taxes	2							2
U.S. GAAP net income (loss)	248	133	(185)	(104)	(245)	(161)	(219)	(533)
Deutsche Telekom's percentage of ownership in investee	36.20%	45.00%	49.99%	50.00%	25.92%	21.35%		
Deutsche Telekom's equity in net earnings (losses) of equity investees under U.S. GAAP	84	60	(92)	(52)	(64)	(34)	(26)	(124)
Consolidation adjustments:								
Goodwill amortization	(2)	(80)	(54)			(33)		(169)
Intangible asset amortization		(12)						(12)
Impairment charges					(13)	(226)		(239)
Other	8	(27)	(7)	(2)	2	(4)	(79)	(109)

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Deutsche Telekom's equity in net earnings (losses) of equity investees, including consolidating adjustments, under U.S. GAAP	90	(59)	(153)	(54)	(75)	(297)	(105)	(653)
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For the year ended December 31, 2000

	MTS	PTC	Ben <sup>(1)</sup>	Virgin Mobile	Telesens	comdirect	Other Equity Investments	Total Equity Investments
	(millions of \$)							
Net revenue	579	879	246	113	42	314	5,533(a)	7,706
Total expenses	(433)	(841)	(470)	(290)	(84)	(288)	(796)	(3,202)
Income (loss) before income taxes and minority interest	146	38	(224)	(177)	(42)	26	4,737	4,504
Income taxes	(55)	(8)			12	(23)	(84)	(158)
Minority interest	6							6
U.S. GAAP net income (loss)	97	30	(224)	(177)	(30)	3	4,653	4,352
Deutsche Telekom's percentage of ownership in investee	36.20%	45.00%	49.99%	50.00%	25.92%	21.35%		
Deutsche Telekom's equity in net earnings (losses) of equity investees under U.S. GAAP	35	14	(19)	(89)	(8)	1	2,282	2,216
Consolidation adjustments:								
Goodwill amortization	(3)	(55)	(9)			(25)		(92)
Intangible asset amortization		(5)						(5)
Dilution gains	111				72	449		632
Other	16	(6)	(1)	8	4	(1)	(103)	(83)
Deutsche Telekom's equity in net earnings (losses) of equity investees, including consolidating adjustments, under U.S. GAAP	159	(52)	(29)	(81)	68	424	2,179	2,668

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(1) Acquired in October 2000.

(a) Net revenue for the year ended December 31, 2000 include EUR 4.6 billion in proceeds from the sale by DT-FT Italian Holding GmbH of its 49% ownership interest in WIND Telecomunicazioni S.p.A.

**Balance Sheet**

As of December 31, 2001

	MTS	PTC	Ben	Virgin Mobile	Telesens	comdirect	Other Equity Investments	Total Equity Investments
	(millions of )							
Current assets	543	300	126	80	34	2,017	712	3,812
Non-current assets	1,422	1,823	1,032	41	101	957	4,449	9,825
<b>Total assets</b>	<b>1,965</b>	<b>2,123</b>	<b>1,158</b>	<b>121</b>	<b>135</b>	<b>2,974</b>	<b>5,161</b>	<b>13,637</b>
Current liabilities	352	248	526	105	39	2,394	1,390	5,054
Non-current liabilities	436	1,591	10	282	30	2	2,120	4,471
Minority interest	16						12	28
Shareholders equity (deficit)	1,161	284	622	(266)	66	578	1,639	4,084
<b>Total liabilities and shareholders equity (deficit)</b>	<b>1,965</b>	<b>2,123</b>	<b>1,158</b>	<b>121</b>	<b>135</b>	<b>2,974</b>	<b>5,161</b>	<b>13,637</b>
Deutsche Telekom's investment in and advances to equity investees at cost plus equity in undistributed earnings (losses) since acquisition	435	1,215	888		9	328	1,223	4,098
Deutsche Telekom's percentage of ownership in investee	36.20%	45.00%	49.99%	50.00%	25.92%	21.35%		

**(d) Derivatives***Accounting Standard*

Deutsche Telekom applies Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133) as amended. This statement became effective for Deutsche Telekom on January 1, 2001 and establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to hereafter as derivatives) and for hedging activities. It requires recognition of all derivatives on the balance sheet at fair value, regardless of the hedging relationship designation. Derivative instruments must be classified as hedging instruments (either fair value hedges, cash flow hedges, foreign currency fair value hedges, foreign currency cash flow hedges or hedges of the net investment in a foreign operation) or non-hedging instruments, and the

accounting treatment of derivative instruments and hedged items depends on this classification.

Changes in the fair value of derivatives designated in qualifying highly effective fair value hedging relationships (including foreign currency fair value hedging relationship) are recognized in current period earnings along with fair value changes of the hedged item that are attributable to the hedged risk reflected as adjustments to the carrying value of the hedged item. Changes in the fair value of derivatives designated in qualifying, highly effective, cash flow hedging relationships (including foreign currency cash flow hedging relationship) are recorded in other comprehensive income (outside earnings) and recognized in earnings when the hedged item affects earnings. Any hedge ineffectiveness is recorded in current-period earnings. If a financial instrument is designated as a hedge of a net investment in a foreign operation, the changes in the hedging instrument's fair value, are recorded in other comprehensive income as part of the cumulative translation adjustment. Changes in the fair value of derivative instruments that are not designated as hedging instruments are recognized in earnings when they occur.

*Risk Management Policies*

Deutsche Telekom is exposed to foreign currency risks, interest rate risks and equity price risks arising from fluctuations in exchange rates, interest rates and quoted share prices. Deutsche Telekom's risk policy generally takes into account only risks affecting the Group's cash flows. Therefore, fair value changes of

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investments arising from fluctuations in quoted share prices as well as foreign currency translation risks inherent in Deutsche Telekom's net investments in foreign entities are normally not hedged. Deutsche Telekom does not enter into derivative financial instruments for trading purposes or other speculative purposes.

Deutsche Telekom is exposed to interest rate risks, primarily in the European Union, in Great Britain and in the United States. In order to mitigate the impact of interest rate fluctuations in these areas Deutsche Telekom separately manages interest rate risk for euro, U.S. dollar and British pound denominated liabilities. Under consideration of the existing and forecasted debt structure, Deutsche Telekom enters into interest rate derivatives to modify the interest payments on bonds, other liabilities and cash investments to adjust their risk profile to the defined target mixture of floating-rate and fixed-rate interest as defined by the Management Board. Interest rate swaps in particular are used, in addition to purchased interest rate options (such as caps and collars).

Foreign currency risks arise from Telekom's investing, financing and operating activities. Since Deutsche Telekom's corporate objective is pursued through its commercial operations meaning the sale of telecommunications services unwanted foreign currency risk exposures are normally managed, provided the risks would affect the Group's cash flows. Foreign currency risks that do not affect the Group's cash flows (risks resulting from the translation of Deutsche Telekom's foreign entities' assets and liabilities to the Group's reporting currency) generally remain unhedged. However, in specific circumstances, Deutsche Telekom may seek to hedge the foreign currency translation risk inherent in certain foreign entities.

For purposes of managing foreign currency risks, Deutsche Telekom makes a distinction between investing, financing and operating activities:

Foreign currency risks in the investment area arise from the acquiring, holding and divesting of investments in foreign entities. Translation risk associated with our net investments in foreign entities was not hedged at December 31, 2002 except for our net investment in T-Mobile USA. At December 31, 2002 there were no hedged forecasted acquisitions or sales of foreign entities.

Foreign currency risks in the financing area arise from foreign currency denominated financial liabilities. Deutsche Telekom enters into cross-currency interest rate swaps and foreign currency forward contracts in order to effectively convert foreign currency denominated financial liabilities into the Group companies' functional currencies (primarily euro, U.S. dollar and British pound). At December 31, 2002, foreign currency denominated liabilities for which foreign currency risk is managed consist primarily of bonds and medium term notes in Japanese yen, British pound, Czech koruna and Polish zloty as well as bank loans in U.S. dollar. Foreign currency risks related to a variety of short-term foreign currency denominated intercompany loans are mitigated with forward currency contracts.

Foreign currency risks in the operating area are limited because individual Group entities conduct most of their activities in their respective functional currency. However, some Group entities are exposed to foreign currency transaction risk related to certain anticipated foreign exchange payments primarily for capital expenditures and expense payments to international telecommunications carriers for completing international calls made by our domestic customers. Deutsche Telekom occasionally enters into foreign currency forward contracts or purchases foreign currency options to hedge these anticipated payments up to a maximum of one year.

*Initial Application of SFAS No. 133*

On January 1, 2001, Deutsche Telekom recognized all freestanding derivative instruments as either assets or liabilities and measured them at fair value under U.S. GAAP. The differences between the derivatives' previous carrying amounts and their fair values were reported as transition adjustments. Because Deutsche Telekom's foreign currency forward contracts, foreign currency options and cross-currency interest rate swaps were already recognized at fair value at December 31, 2000, transition adjustments were only required for certain interest rate derivatives.

The majority of Deutsche Telekom's interest rate derivatives entered into before January 1, 2001 were used to create synthetic financial instruments (mostly synthetic variable rate debt). Thus, for example, Deutsche Telekom sold 30 year fixed-rate U.S. dollar notes and simultaneously entered into a combination of interest rate swaps and cross-currency interest swaps to effectively create a 10 year fixed-rate British pound borrowing. Adjusting the interest rate swaps' previous carrying amounts (accrued interest payables and

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receivables) to their fair values resulted in a net gain of EUR 226 million (after taxes of EUR 144 million) on January 1, 2001, which was reported as a cumulative-effect-type adjustment of net income.

A smaller number of interest rate swaps as well as interest rate collars entered into before January 1, 2001 were used to reduce the cash flow exposure of floating-rate British pound liabilities. The transition adjustments for these derivatives resulted in a loss of EUR 22 million (after taxes of EUR 10 million) which was reported as a cumulative-effect-type adjustment to accumulated other comprehensive income on January 1, 2001. The adjustment to accumulated other comprehensive income is reclassified into earnings over the residual period that interest payments on the floating-rate liabilities affect earnings. The derivatives were not redesignated as hedging instruments at January 1, 2001.

Deutsche Telekom's other interest rate derivatives were already recognized at fair value on December 31, 2000 and no transition adjustments for these derivatives were therefore required.

No derivative or nonderivative hedging instrument entered into before January 1, 2001 was designated anew as a hedging instrument at January 1, 2001 except for a British pound-denominated borrowing that hedged the foreign currency exposure of a portion of Deutsche Telekom's net investment in One 2 One.

*Post-Transition-Date Accounting under SFAS No. 133*

Using financial analysis to identify the extent of a derivative's potential gain or loss, Deutsche Telekom decides on the date that it enters into a derivative contract whether it is efficient to seek hedge accounting for the derivative. If Deutsche Telekom elects to apply hedge accounting, it puts in place the appropriate hedge documentation and effectiveness testing routine at inception of the hedge.

**Fair Value Hedges**

In 2002, Deutsche Telekom had pay-variable, receive-fixed interest rate swaps and cross-currency interest rate swaps to hedge the fair value risk of certain fixed rate debt. The Company designated these interest rate swaps as hedging instruments in qualifying, highly effective, fair-value hedging relationship of euro denominated fixed-rate liabilities. The Company designated these cross-currency interest rate swaps as hedging instruments in qualifying, highly effective, fair-value hedging relationships of foreign currency denominated fixed-rate liabilities.

In the middle of 2001, Deutsche Telekom entered into pay-variable, receive-fixed interest rate swaps to hedge the fair value risk of fixed rate euro debt. These interest rate swaps were designated as fair value hedging instruments. They meet all the required criteria of SFAS No. 133 for the assumption of perfect hedge effectiveness. Accordingly, gains from adjusting the carrying amounts of the interest rate swaps to their fair values of EUR 68 million and from adjusting the carrying amount of the debt (resulting in losses of EUR 68 million) completely offset each other.

For the year ended December 31, 2002, Telekom recognized in U.S. GAAP earnings no ineffectiveness for all of the Company's fair-value hedges. All components of each interest rate swap's gain or loss were included in the assessment of hedge effectiveness.

**Cash Flow Hedges**

During 2002, Deutsche Telekom designated certain pay-fixed, receive-variable U.S. dollar interest rate swaps as hedging instruments in qualifying, highly effective, cash-flow hedges of forecasted interest payments. During 2002 Deutsche Telekom reported losses on these swaps of EUR 145 million (after taxes of EUR 29 million) in accumulated other comprehensive income. These forecasted interest payments are hedged over a period of up to five years.

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Additionally, during 2002, Deutsche Telekom designated certain existing pay-fixed, receive-variable GBP interest rate swaps as hedging instruments in qualifying, effective, cash-flow hedges of forecasted interest payments under a syndicated loan agreement based on a principal amount of GBP 500 million.

During 2002, Deutsche Telekom reported losses on these swaps of EUR 11 million (after taxes of zero) in accumulated other comprehensive income. These forecasted interest payments are hedged over a period of up to three years.

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The ineffective portion of these swaps was EUR 0.2 million, which was recognized as a loss under U.S. GAAP.

Deutsche Telekom reclassified from accumulated other comprehensive income to earnings a EUR 88 million loss (after taxes of zero) related to certain of its discontinued cash flow hedges for which Deutsche Telekom determined that it was probable the hedged forecasted transactions would not occur by the end of the originally specified time period or within a reasonable period of time thereafter.

In addition, Deutsche Telekom reclassified from accumulated other comprehensive income to earnings a EUR 9 million loss (after taxes of zero) related to the transition adjustment recorded at January 1, 2001. Deutsche Telekom expects EUR 46 million of losses deferred in accumulated other comprehensive income to be reclassified into earnings during the next twelve months.

During 2001, losses on interest rate derivatives of EUR 22 million (after taxes of 10 million) were reported in accumulated other comprehensive income on January 1, 2001 as a result of the initial application of SFAS No. 133. Losses of EUR 8 million (after taxes of EUR 3 million) associated with this transition adjustment were reclassified into earnings during 2001. The same amount is expected to be reclassified as earnings within the next twelve months.

**Net Investment Hedges**

During 2002, Deutsche Telekom continued to hedge foreign currency translation risk associated with shares of preferred stock in T-Mobile USA, which form a part of Deutsche Telekom's net investment in T-Mobile USA. During 2002, Deutsche Telekom changed the hedging instruments designated as hedges of its net investment in T-Mobile USA in the form of shares of redeemable preferred stock. Before the change, Telekom hedged the foreign currency exposure inherent in the redeemable preferred shares with short-term foreign currency forward contracts. After the change the hedging instruments are foreign currency forward contracts (still short-term), five-year cross-currency interest rate swaps (Deutsche Telekom pay U.S. dollar at fixed rates and receive euro at fixed rates) and U.S. dollar denominated long-term debt, respectively. Each hedging instrument is designated in a separate, qualifying hedging relationship. During 2002, Deutsche Telekom recorded to cumulative translation adjustment, a component of other comprehensive income, a net gain of EUR 960 million (after taxes of zero) related to derivative and nonderivative hedging instruments designated in a hedge of Deutsche Telekom's net investment in T-Mobile USA.

In 2001, Deutsche Telekom hedged the foreign currency translation risk inherent in a portion of its net investment in One 2 One with British pound denominated borrowings through 2001. At June 1, 2001, Deutsche Telekom designated U.S. dollar forward sale contracts (U.S. dollar versus euro sales) as hedges of the foreign currency translation risk inherent in shares of the preferred stock in VoiceStream, which form a part of Deutsche Telekom's net investment in VoiceStream. Gains and losses on these derivative and nonderivative financial instruments were reported in other comprehensive income (shareholders' equity) along with gains and losses resulting from the translation of the net assets of the mentioned foreign subsidiaries at current spot rates.

**All Other Derivatives**

Deutsche Telekom also enters into certain derivative transactions, that do not qualify for hedge accounting under SFAS No. 133, but do provide for effective economic hedges under the Group's risk management policies.

For derivatives that hedge the foreign currency transaction risk of recognized foreign currency denominated assets or liabilities, Deutsche Telekom does not seek special hedge accounting because the transaction gain or loss on the economically hedged foreign currency denominated asset or liability will be reported in earnings concurrently with the gain or loss on the derivative.

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For the purpose of the balance sheet presentation in accordance with U.S. GAAP as of December 31, 2002, Deutsche Telekom reported the fair value of derivative instrument assets of EUR 0.9 billion in other non-current assets and derivative instrument liabilities of EUR 1.3 billion in other current liabilities. These amounts reflect no netting of derivative instrument assets and liabilities.

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Pursuant to German law, the Federal Agency provides certain services to Deutsche Telekom, Deutsche Postbank and Deutsche Post and has certain rights and responsibilities with respect to the administration of the common affairs of these companies. For example, the Federal Agency is responsible for concluding general collective bargaining agreements (Manteltarifverträge) on behalf of these entities with employees relating only to certain non-wage benefits, rules of conduct and other general terms of employment. These agreements only become effective with the consent of the affected entity. The Federal Agency's right to conclude these agreements does not affect Deutsche Telekom's right to negotiate particular terms of employment, including wages, salaries and conditions of employment, independently on its own behalf. The Federal Agency also administers the health insurance fund for civil servants (Postbeamtenkrankenkasse) and the pension fund for non-civil servants (VAP) employed by Deutsche Telekom, Deutsche Postbank, Deutsche Post and others. The Federal Agency has certain additional responsibilities and rights with respect to civil servants employed by Deutsche Telekom, Deutsche Post and Deutsche Postbank. The Federal Agency has the right to provide advice concerning the coordination of the activities of Deutsche Telekom, Deutsche Postbank and Deutsche Post, particularly, with respect to their public image, issues that may arise if the business plans of these entities conflict and, upon request, with respect to certain personnel issues.

Services provided by the Federal Agency pursuant to applicable law are rendered on the basis of service agreements between Deutsche Telekom, Deutsche Postbank or Deutsche Post, on the one hand, and the Federal Agency, on the other. Since German law currently requires that each of Deutsche Telekom, Deutsche Postbank and Deutsche Post enter into a service agreement with the Federal Agency covering the services described above, Deutsche Telekom has not considered entering into arrangements with third parties for the provision of these services. The total costs of the Federal Agency, consisting mainly of personnel costs for its employees, are allocated pursuant to the cost attribution system of the Federal Agency in accordance with actual expenses. Costs of the Federal Agency incurred in connection with providing these services are funded from fees agreed upon and charged to Deutsche Telekom, Deutsche Post and Deutsche Postbank. Deutsche Telekom paid costs of EUR 64 million, EUR 70 million, and EUR 78 million in 2002, 2001, and 2000, respectively.

*Federal Republic as Regulator*

The Federal Republic's role as regulator is independent and distinct from its role as shareholder. This regulatory function is exercised by the Regulatory Authority.

*Federal Republic and Affiliated Entities as Customers*

The Federal Republic is Deutsche Telekom's largest customer and purchases services on an arm's-length basis. Deutsche Telekom deals with the various departments and agencies of the Federal Republic of Germany as separate customers, and the provision of services to any one department or agency does not constitute a material part of Deutsche Telekom's revenues. Deutsche Telekom also entered into contracts to provide telecommunications services to entities affiliated with the Federal Republic, principally Deutsche Post, on an arm's-length basis in the ordinary course of business.

Deutsche Telekom is a partner in a consortium that has contracted with the Federal Republic to develop and operate a toll collection system for the use by certain commercial vehicles of roadways in Germany. Pursuant to this arrangement, Deutsche Telekom has, along with its partners, guaranteed, on a joint and several basis, the successful completion and operation of the toll collection system. In the event that the toll collection system is not completed on schedule, or does not operate effectively upon completion, the amount of revenues to be received by the operating joint venture company pursuant to this arrangement may be significantly reduced, and the operating joint venture company may be subject to significant penalties as well. Further, there are no restrictions on the ability of the Federal Republic to recover damages.

*Arrangement with Deutsche Post*

Deutsche Telekom entered into an agreement with Deutsche Post AG in 2000 that calls for Deutsche Telekom to provide, among other things, information technology and corporate network services to Deutsche Post. In return, Deutsche Post provides distribution and transportation, printing, warehousing and other

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services. The objective of the arrangement is to allow each company to focus on its core competencies and dispose of peripheral activities. The arrangement resulted in a net transfer of 1,500 Deutsche Telekom employees to Deutsche Post in 2001 and 2000.

*Arrangements with Deutsche Postbank AG*

Deutsche Telekom has a credit facility with Deutsche Postbank AG amounting to EUR 200 million in 2002, 2001 and 2000. As of December 31, 2002 that credit facility was used up to GBP 43 million (EUR 66 million) with an interest rate of 4.3% per year.

Deutsche Telekom has agreements with a number of banks, including Deutsche Postbank, pursuant to which it can draw on credit facilities up to EUR 12 billion according to a consortium credit facility agreement. The level of the interest rates depends on Deutsche Telekom's rating, the amount of the consortium credit and the LIBOR rate plus margin ranking to be applied, from 0.275% to 0.500%. The loan commitment fee is between 0.050% - 0.200% and also depends on Deutsche Telekom's rating. There were no outstanding debts relating to the Deutsche Telekom consortium credit at the end of 2002.

*Arrangements with KfW*

In 2000, our Dutch finance subsidiary, Deutsche Telekom International Finance B.V., entered into three loan agreements with KfW in the amount GBP 150 million each, which are guaranteed by Deutsche Telekom AG. The level of the interest rates depends on our rating. The loans have a maturity of five, seven and ten years, respectively.

*Acquisition of UMTS Licenses from Federal Republic*

In 2000, Deutsche Telekom acquired UMTS licenses from the Federal Republic at an auction price of EUR 8,540 million.

*Federal Republic Guarantees*

Under German law, all liabilities of Deutsche Telekom outstanding on January 2, 1995, the date of Deutsche Telekom's registration in the Commercial Register (*Handelsregister*), became guaranteed by the Federal Republic. This guarantee replaced the Federal Republic's obligations with respect to Deutsche Telekom's liabilities when it was a state-owned special asset. Liabilities incurred after January 2, 1995 are not guaranteed by the Federal Republic. See note (29) for additional information.

*Pension Contributions for Civil Servants*

Civil servants (*Beamte*) employed by Deutsche Telekom are entitled to pension benefits provided by the Federal Republic. Under German law, Deutsche Telekom is required to make annual contributions to a special pension fund (*Unterstützungskasse*) established to fund these pension obligations. Deutsche Telekom's contributions amounted to EUR 838 million, EUR 845 million, and EUR 895 million in 2002, 2001, and 2000, respectively.

*Real Estate Investigation*

Deutsche Telekom is advancing funds to cover the legal expenses being incurred by current and former board members in connection with the Bonn public prosecutors investigation of certain real estate valuation-related questions. These funds will be required to be repaid to Deutsche Telekom if there is a final determination that these individuals violated the law.

*Telecommunication Services*

Deutsche Telekom provides telecommunications services to numerous companies, mainly throughout Europe, in the ordinary course of business, including firms in which it holds an ownership interest and firms with which certain members of the Supervisory Board are affiliated.

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In June 2001, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 143 ( SFAS No. 143 ), *Accounting for Asset Retirement Obligations*, which addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development or normal use of the asset. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated long-lived asset and is depreciated over the asset's useful life. The liability is accreted to its present value each period through charges to operating expense. If the obligation is settled for other than the carrying amount of the liability, a gain or loss on settlement is recognized. The Company is required and plans to adopt the provisions of SFAS No. 143, effective January 1, 2003. To accomplish this, the Company must identify all legal obligations for asset retirement obligations, if any, and determine the fair value of these obligations on the date of adoption. The determination of fair value is complex and will require gathering market information and the development of cash flow models. Additionally, the Company will be required to develop processes to track and monitor these obligations. The Company has not completed its assessment of the impact SFAS No. 143 will have on its results of operations, financial position and cash flows.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, ( SFAS No. 146 ) which replaces Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The types of costs affected by this Standard include certain employee severance costs, contract termination costs and costs to consolidate or close facilities or relocate employees. SFAS No. 146 requires that a liability for costs associated with exit or disposal activities be recognized only when the liability is irrevocably incurred (rather than at the date of management's commitment to an exit or disposal plan). The recognized liability is to be initially measured at fair value and subsequently adjusted for changes in estimated cash flows. The provisions of SFAS No. 146 are effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on its results of operations, financial position and cash flows.

In November 2002, the FASB issued Interpretation No. 45 ( FIN 45 ), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 clarifies and expands the disclosure requirements related to guarantees and product warranties, and requires a guarantor to recognize a liability for the fair value of the obligation it assumes under that guarantee. The Company adopted the disclosure requirements applicable to financial statements for periods ending after December 15, 2002. The initial recognition and measurement provisions are applicable prospectively to guarantees issued or modified after December 31, 2002. The Company does not expect the adoption of FIN 45 to have a material impact on its results of operations, financial position and cash flows.

In December 2002, the Emerging Issues Task Force reached a consensus in EITF Issue 00-21 ( EITF 00-21 ), *Accounting for Revenue Arrangements with Multiple Deliverables*. The Issue addresses a vendor's accounting for transactions involving the delivery of more than one product or service, and when it is necessary to separate the transaction into individual component deliverables, each with its own separate earnings process. If the conditions requiring separate revenue recognition exist, revenue is allocated among the different deliverables based on their relative fair values (the relative fair value of each of the component deliverables to the aggregated relative fair value of the bundled deliverables), with revenue for each component deliverable recognized when the revenue is realized and earned. The Company is required and plans to adopt the provisions of EITF 00-21, effective July 1, 2003. To accomplish this, the Company must identify and determine the fair value of the component deliverables. The determination of fair values in the mobile and systems business is complex, as some of the components are price sensitive and volatile in a competitive marketplace. Additionally, the Company will be required to develop processes to update the relative fair values based upon competitive market conditions. The Company is still assessing the impact that EITF 00-21 will have on its results of operations, financial position and cash flows.

In January, 2003, the FASB issued Interpretation No. ( FIN 46 ), *Consolidation of Variable Interest Entities* ( VIEs ). This interpretation changes the accounting and requirements for consolidation and disclosure of certain entities, including special purpose entities ( SPEs ). Under FIN 46, an entity is

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considered a VIE (and subject to consolidation) if its total equity at risk is determined insufficient to finance its activities without additional subordinated financial support, or if its equity investors lack certain characteristics that represent a controlling financial interest. An entity that is considered a VIE would be required to be consolidated by the enterprise that holds a majority of its variable interests (that is, the enterprise that has the most exposure to the economic risks and the potential rewards from changes in the values of the VIE's assets and liabilities). The Company has adopted Interpretation's disclosure provisions, effective for all financial statements issued after January 31, 2003, which require all holders of variable interests in VIEs to disclose the nature, purpose, size and activities of the VIEs, including the maximum exposure to losses. The consolidation requirements apply to all new VIEs created on and after February 1, 2003, with transitional provisions for VIEs that existed prior to that date. The Company plans to adopt the initial and transition consolidation provisions of FIN 46 on February 1 and July 1, 2003, respectively. To accomplish this, Deutsche Telekom and its operating subsidiaries must identify all VIEs, if any, and determine the expected loss and expected residual returns associated with our variable interests. The determination of expected losses and expected residual returns is complex and will require us to develop cash flow models. Deutsche Telekom does not expect the adoption of FIN 46 to have a material impact on its results of operations, financial position and cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* ( SFAS No. 148 ), which amends SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS No. 123 ). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in the financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition provisions are effective for financial statements for fiscal years ending after December 15, 2002. The enhanced disclosure requirements are effective for periods beginning after December 15, 2002. Pursuant to SFAS No. 123, the Company elected to apply Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for our stock-based compensation plans. Refer to notes (26) and (41) to the consolidated financial statements for discussion of the effect on net income (loss) and other related disclosures had we accounted for these plans under SFAS No. 123, *Accounting for Stock-Based Compensation* .

*New U.S. GAAP Rules Adopted in 2002:*

On January 1, 2002, Deutsche Telekom adopted the new U.S. accounting standards addressing the treatment of business combinations and of goodwill and other intangible assets (SFAS No. 141 and No. 142). Upon adoption, as required by SFAS No. 142, Deutsche Telekom ceased amortizing goodwill, as well as the U.S. FCC spectrum licenses used by Deutsche Telekom's subsidiaries T-Mobile USA and Powertel, as these licenses are deemed to have an indefinite life.

SFAS No. 142 requires Deutsche Telekom to perform an impairment test for goodwill and indefinite life intangible assets annually. Deutsche Telekom therefore tests the value of its indefinite life intangible assets and goodwill at the end of the third quarter of each fiscal year, or earlier when indicators of impairment exist. In assessing whether the goodwill of a reporting unit shall be tested for impairment between annual tests, Deutsche Telekom's considerations included the effects of significant adverse changes in legal factors; market and economic conditions; the results of the Group companies' operational performance and strategic plans; adverse actions by regulators; unanticipated changes in competition and market share; the potential for the sale or disposal of a significant portion of reporting unit; and its market capitalization to the extent that stock market price trends are reflective of current industry conditions and expected long-term industry performance.

Upon adoption of SFAS No. 142, Deutsche Telekom completed its transitional impairment tests as of January 1, 2002, and determined that there was no indication of impairment at that time. Deutsche Telekom tested reporting units in each segment in connection with the annual impairment test performed during the third quarter of 2002. Specifically, the T-Mobile and T-Com segments were tested for impairment following the annual budgeting process, completed after the strategic business review. This company-wide business review led to strategic funding cut-backs which resulted in revisions being made to the earnings forecasts for the next 10 years.





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As a result of the revised forecasts, Deutsche Telekom recorded pre-tax impairment charges totaling approximately EUR 14,567 million for goodwill and EUR 9,923 million for spectrum licenses. The charges reflect changes to current conditions and future expectations of growth in the wireless industry in the United States and the United Kingdom, the increased cost of capital and future expectations of growth in the wireless industry, and changes in future funding commitments for the reporting unit. Fair values were determined using measurements techniques, generally based on estimated discounted cash flows.

The following table reconciles reported net income (loss) and basic and diluted earnings (loss) per share under U.S. GAAP in the period to exclude amortization related to goodwill and intangible assets, net of any related tax effects, assuming the adoption of SFAS No. 142 had occurred on January 1, 2000:

	For the year ended December 31,		
	2002	2001	2000
	(millions of \$)		
Reported net income (loss)	(22,098)	523	9,269
Add back: Goodwill amortization		2,918	567
Add back: License amortization, net		336	
Adjusted net income (loss)	(22,098)	3,777	9,836
Basic earnings (loss) per share:			
Reported net income	(5.31)	0.14	3.06
Goodwill amortization		0.79	0.19
License amortization		0.09	
Adjusted net income (loss)	(5.31)	1.02	3.25
Diluted earnings (loss) per share:			
Reported net income	(5.31)	0.14	3.06
Goodwill amortization		0.79	0.19
License amortization		0.09	
Adjusted net income (loss)	(5.31)	1.02	3.25

The changes in the carrying amount of goodwill for the segments and in total for the year ended December 31, 2002 are as follows:

	T-Com	T-Mobile	T-Systems	T-Online	Other	Total
	(millions of \$)					
Balance at December 31, 2001	2,956	33,386	4,477	1,939	0	42,758(1)
Impairment charges	(1,657)	(12,910)			0	(14,567)
Other	371	(1,537)	307	(26)	6	(879)
Balance at December 31, 2002	1,670	18,939	4,784	1,913	6	27,312

(1) Certain reclassifications have been made to conform to the current year presentation.

The following table reflects the components of amortizable intangible assets for U.S. GAAP purposes as of December 31, 2002 and 2001, respectively:

	As of December 31, 2002		As of December 31, 2001	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount <sup>(1)</sup>	Accumulated Amortization
	(millions of )		(millions of )	
Amortized intangible assets:				
UMTS licenses	18,085		17,095	
Other intangible assets	11,582	5,923	10,911	3,460
Total amortized intangible assets	29,667	5,923	28,006	3,460

(1) Certain reclassifications have been made to conform to the current year presentation.

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Deutsche Telekom's U.S. GAAP carrying value of non-amortized intangible assets, mainly comprised of FCC licenses, amounted to EUR 23.2 billion and EUR 10.5 billion at December 31, 2001 and 2002, respectively.

The following table presents current and expected amortization expense for other identifiable intangible assets for the current year and the subsequent five years.

	<u>Amount</u>
	(millions of EUR)
Aggregate amortization expense:	
For the year ended December 31, 2002	2,830
Expected amortization expense:	
For the years ending December 31,	
2003	1,778
2004	1,881
2005	1,465
2006	1,275
2007	1,250

The above table represents Deutsche Telekom's estimate regarding future amortization of amortizable intangible assets as they are on Deutsche Telekom's balance sheet as of December 31, 2002. It is therefore likely that future amortization charges for amortizable assets will be higher, as the above figures do not include the impact of any future investments or capital expenditure in intangible assets.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***(g) Subsequent Events***

In January 2003, Deutsche Telekom issued a EUR 1 billion bond with a 5-year term via its financing subsidiary, Deutsche Telekom International Finance B.V. The bond bears interest at 5.77% per annum. The proceeds of the bond were used to repay maturing debt.

In addition, Deutsche Telekom issued a mandatory convertible bond in February 2003, via its financing subsidiary Deutsche Telekom International Finance B.V., generating proceeds of issue totaling approximately EUR 2.3 billion. This mandatory convertible bond is convertible to shares of Deutsche Telekom no later than June 2006 at a conversion rate that depending on share price performance, may vary from a ratio of 3,417.1679 shares to 4,237.2881 shares for each bond (EUR 50,000 nominal amount). The bond bears interest at 6.5% per annum.

In January 2003, Deutsche Telekom sold its remaining six regional cable companies to a consortium of financial investors including Apax, Goldman Sachs Capital Partners and Providence Equity for EUR 1.7 billion. The EU antitrust authorities approved the sale in early March; the transaction was completed in mid-March 2003.

In February 2003, Deutsche Telekom transferred all the shares it held in its subsidiary T-Mobile International AG to a fully-owned direct subsidiary of Deutsche Telekom AG. Following this transaction, T-Mobile International AG was converted into a limited partnership under German law (T-Mobile International AG & Co. KG). As a result of this transaction, the results of T-Mobile International will be included in the tax consolidation group of Deutsche Telekom AG.

Bonn, March 17, 2003

Deutsche Telekom AG

Board of Management

Kai-Uwe Ricke  
Josef Brauner  
Dr. Heinz Klinkhammer  
Konrad F. Reiss

Dr. Karl-Gerhard Eick  
Thomas Holtrop  
Rene Obermann

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**BEN NEDERLAND HOLDING B.V.**

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**DIRECTORS**

R.G.W. Holekamp (appointed July 4, 2001)

S.M. Fries (appointed July 4, 2001)

J.J.A. van Leeuwen (appointed July 4, 2001)

W.A.L. Schrijver (appointed July 4, 2001; resigned October 16, 2001)

P.E. de Weerd ( June 18, 2001)

R.D. Whiteside (resigned December 7, 2001)

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**TO THE SHAREHOLDERS OF**

**BEN NEDERLAND HOLDING B.V.**

**REPORT OF INDEPENDENT ACCOUNTANTS**

We have examined the accompanying consolidated balance sheets of Ben Nederland Holding B.V., Amsterdam, and its subsidiaries as of December 31, 2001 and 2000 and the related consolidated profit and loss accounts and statements of cash flows, for each of the three years in the period ended December 31, 2001, all expressed in Euros. Our examinations of these statements were made in accordance with auditing standards generally accepted in the United States and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Ben Nederland Holding B.V., Amsterdam, and its subsidiaries at December 31, 2001 and 2000, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the Netherlands.

As discussed in Note 2 to the financial statements, the Company changed its method of capitalizing asset construction costs in 2001 and ceased the capitalization of interest costs related to assets under construction in 2000.

Accounting principles generally accepted in the Netherlands vary in certain respects from accounting principles generally accepted in the United States. The application of the latter would have affected the determination of consolidated net loss expressed in Euros for each of the three years in the period ended December 31, 2001 and the determination of consolidated stockholders' equity and consolidated financial position also expressed in Euros at December 31, 2001 and 2000 to the extent summarized in Note 16 to the consolidated financial statements.

PricewaterhouseCoopers N.V.

Amsterdam, The Netherlands

April 24, 2002

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Table of Contents**BEN NEDERLAND HOLDING B.V.****CONSOLIDATED BALANCE SHEETS****AT DECEMBER 31, 2001 AND 2000**

(After proposed appropriation of the result for the years)

(Amounts expressed in thousands of Euros)

	<b>2001</b>	<b>2000</b>
	<b>000</b>	<b>000</b>
<b>ASSETS</b>		
<b>FIXED ASSETS</b>		
Intangible fixed assets	548,075	549,369
Tangible fixed assets	460,752	335,538
Financial fixed assets		23
	<hr/>	<hr/>
Total fixed assets	1,008,827	884,930
<b>CURRENT ASSETS</b>		
Short term loans	2,680	6,421
Receivables	83,715	86,142
Inventory	13,064	14,228
Cash and bank balances	26,251	13,166
	<hr/>	<hr/>
Total current assets	125,710	119,957
	<hr/>	<hr/>
<b>TOTAL ASSETS</b>	<b>1,134,537</b>	<b>1,004,887</b>
	<hr/>	<hr/>
<b>SHAREHOLDERS EQUITY &amp; LIABILITIES</b>		
TOTAL SHAREHOLDERS EQUITY	608,549	807,415
CURRENT LIABILITIES	525,988	197,472
	<hr/>	<hr/>
<b>TOTAL SHAREHOLDERS EQUITY &amp; LIABILITIES</b>	<b>1,134,537</b>	<b>1,004,887</b>
	<hr/>	<hr/>

The accompanying notes form an integral part of these financial statements.

**Table of Contents****BEN NEDERLAND HOLDING B.V.****CONSOLIDATED PROFIT AND LOSS ACCOUNTS****FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

(Amounts expressed in thousands of Euros)

	<b>2001</b>	<b>2000</b>	<b>1999</b>
	<b>000</b>	<b>000</b>	<b>000</b>
Net sales	447,527	244,842	66,655
Cost of sales <sup>(1)</sup>	(226,546)	(156,633)	(69,757)
Gross profit	220,981	88,209	(3,102)
Operating expenses	(410,039)	(316,390)	(172,585)
Other operating income	482	1,229	470
Operating loss	(188,576)	(226,952)	(175,217)
Net financial expense	(10,290)	(12,427)	(3,716)
Extraordinary income			16,504
Net loss	(198,866)	(239,379)	(162,429)

(1) Cost of sales excludes depreciation and amortization, which is included in operating expenses.  
The accompanying notes form an integral part of these financial statements.

Table of Contents**BEN NEDERLAND HOLDING B.V.****CONSOLIDATED CASH FLOW STATEMENTS****FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

(Amounts expressed in thousands of Euros)

	2001	2000	1999
	000	000	000
<b>CASH FLOW FROM OPERATING ACTIVITIES</b>			
Result after taxation for the period	(198,866)	(239,379)	(162,429)
Adjustments:			
Depreciation of tangible and intangible fixed assets	75,032	54,785	29,166
Loss on disposal of financial fixed assets	23		
Changes in working capital:			
Decrease/(increase) inventory	1,164	(6,742)	(6,012)
Decrease/(increase) receivables	2,427	(52,982)	(27,495)
Decrease/(increase) short term loans	3,741	557	(3,802)
Decrease/(increase) current liabilities exclusive of shareholder loans	11,947	(46,309)	146,309
	19,279	(105,476)	109,000
Net cash used in operating activities	(104,532)	(290,070)	(24,263)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Investment in tangible fixed assets	(163,433)	(128,965)	(192,197)
Disposal of tangible fixed assets	1,382	1,445	1,135
Investment in intangible fixed assets	(36,901)	(432,018)	(21,464)
Investment in financial fixed assets		(23)	
Net cash used in investing activities	(198,952)	(559,561)	(212,526)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Paid in capital		1,070,714	
Loans from shareholders	316,569	(214,222)	236,857
Net cash provided by financing activities	316,569	856,492	236,857
<b>NET INCREASE IN CASH</b>	<b>13,085</b>	<b>6,861</b>	<b>68</b>
<b>Cash and cash equivalents beginning of year</b>	<b>13,166</b>	<b>6,305</b>	<b>6,237</b>
<b>Cash and cash equivalents end of year</b>	<b>26,251</b>	<b>13,166</b>	<b>6,305</b>

The accompanying notes form an integral part of these financial statements.

**Table of Contents****BEN NEDERLAND HOLDING B.V.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE YEARS ENDED DECEMBER 31, 2001****1. ACTIVITIES**

In accordance with Article 2 of its Articles of Association the principal activities of the company are to participate in, to finance, to collaborate with, to conduct the management of companies and enterprises active in the area of telecommunications and to provide advice and all other services.

Furthermore, the company's objective is to exploit, to apply for and to hold all licenses required for establishing a full-scale mobile telecommunications business in the Netherlands and to maintain and operate a mobile telecommunications infrastructure in the Netherlands.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES*****Basis of presentation***

The accompanying consolidated financial statements have been prepared in accordance with principles of accounting generally accepted in the Netherlands.

***Changes in accounting policies***

In 2001, the Company upgraded its accounting system to identify direct costs of Engineering & Operations employees working on assets under construction. These costs were not separately identifiable in prior years. As a result of the accounting system change, the Company began capitalizing these costs beginning January 1, 2001. Total costs capitalized for the year ended December 31, 2001 were EUR 4,595,000. No such costs were capitalized related to prior years.

Up to January 1, 2000 the Company capitalised interest on construction in progress. As of January 1, 2000 all interest is expensed. The balance of 1,795,000 at December 31, 1999 was charged to income in the year 2000.

***Principles of consolidation***

Group companies included in the consolidated accounts are those in which the company exercises significant influence. All intercompany balances and transactions are eliminated on consolidation.

Group companies included in the consolidated accounts are as follows:

	Domicile	Proportion of voting rights held	
		2001	2000
BEN Nederland B.V	The Hague	100%	100%
BEN Klantenservice B.V	The Hague	100%	100%
3 G-Blue B.V	The Hague		100%

3 G-Blue B.V. merged into Ben Nederland B.V. in 2001.

*Cash flow statement*

The cash flow statements are prepared using the indirect method, in accordance with IAS 7.

*Foreign currencies*

In the profit and loss accounts, all transactions denominated in a currency other than the Euro are translated into Euros at the exchange rate prevailing at the time of the transaction. Assets and liabilities denominated in foreign currencies are translated into Euros at the exchange rates prevailing on the balance sheet dates with differences recorded through the profit and loss account.

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**Table of Contents**

**BEN NEDERLAND HOLDING B.V.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

***Impairment of fixed assets***

The carrying amounts of fixed assets are reviewed annually and written down where necessary for impairment.

***Intangible fixed assets***

Intangible fixed assets are stated at cost less amortisation calculated using the straight-line method over their estimated useful lives.

The DCS-1800 license, acquired in 1998, is carried at cost less amortisation on a straight-line basis from the launch of services to the end of the license period. (15 years).

The UMTS license is carried at cost. This license will be amortised on a straight-line basis, as from the launch of services to the end of the license period. The UMTS license runs through December 31, 2016.

Software licenses and capitalised software development costs are carried at cost less amortisation calculated using the straight-line method evenly over their useful lives of 3 years.

***Tangible fixed assets***

Tangible fixed assets are stated at cost less accumulated depreciation calculated over their estimated useful lives using the straight-line method.

The estimated useful life for certain network equipment was revised during 2000, and this change was applied prospectively. This had the impact of reducing the annual depreciation charge by approximately 9 million.

The annual depreciation rates are:

Installation, machinery and equipment	13%-33%
Furniture and fixtures	20%
Leasehold improvements	10%

***Financial fixed assets***

Participations of less than 20% equity interest are carried at cost. If necessary, provisions are recorded when there are permanent impairments in value. As of 2001, there have been no impairments to date. Income derived from these participations is recognised only when dividends are declared.

***Accounts receivable***

Subscriber and other debtors are stated at nominal value less a provision for doubtful debts.

***Inventory***

Inventory, consisting of packaging, handsets, sim-cards and reload vouchers, is carried at cost. Appropriate allowance is made for obsolete and slow-moving goods.

***Revenue recognition***

Revenues are recorded at the time the service is rendered. Revenues from services rendered are recorded net of discounts and VAT.

***Deferred income tax***

Deferred income tax is provided, using the liability method, for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. Currently enacted tax rates are used to determine deferred income tax.

**Table of Contents****BEN NEDERLAND HOLDING B.V.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

Deferred tax assets relating to the carry forwards of unutilised tax losses are recognised to the extent that it is probable that future taxable income will be available against which the unused tax losses can be utilised.

At December 31, 2001, losses available for carry forward (all indefinite) of 620,988,000 were not recognised in determining the deferred tax asset.

**Interest**

It is the policy of the Company to expense interest as incurred.

**3. FINANCIAL FIXED ASSETS**

	<u>2001</u>	<u>2000</u>
	<u>000</u>	<u>000</u>
Balance at January 1	23	
Additions/(Disposals)	(23)	23
	<u>—</u>	<u>—</u>
Balance at December 31		23
	<u>—</u>	<u>—</u>

Ben Nederland B.V. acquired 50 shares (13%) with a nominal value of 454 in B-Genius, the E-Academy, N.V. on June 5, 2000. The participation has been disposed for NLG 1 in 2001.

**4. INTANGIBLE FIXED ASSETS**

	<u>000</u>
<b>COST</b>	
Balance at January 1, 2001	592,079
Additions	36,901
Disposals	
	<u>—</u>
Balance at December 31, 2001	628,980
	<u>—</u>
<b>ACCUMULATED AMORTISATION</b>	
Balance at January 1, 2001	(42,710)
Amortisation for the year	(38,195)
	<u>—</u>
Balance at December 31, 2001	(80,905)
	<u>—</u>
Net book value at December 31, 2001	548,075
	<u>—</u>

**5. TANGIBLE FIXED ASSETS**



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	Installations, machinery and equipment	Furniture and fixtures	Leasehold improvements	Assets under construction	Total
	000	000	000	000	000
<b>AT COST</b>					
Balance at January 1, 2001	169,436	4,729	92,143	110,791	377,099
Additions	57,693	1,823	24,602	85,951	170,069
Disposals	(1,227)		(132)	(266)	(1,625)
Transfers from assets under construction	24,757		10,545	(41,938)	(6,636)
Balance at December 31, 2001	<u>250,659</u>	<u>6,552</u>	<u>127,158</u>	<u>154,538</u>	<u>538,907</u>
<b>ACCUMULATED DEPRECIATION</b>					
Balance at January 1, 2001	(30,554)	(1,266)	(9,741)		(41,561)
Charge for the year	(24,560)	(1,216)	(11,061)		(36,837)
Disposals	235		8		243
Balance at December 31, 2001	<u>(54,879)</u>	<u>(2,482)</u>	<u>(20,794)</u>		<u>(78,155)</u>
Net book value at December 31, 2001	<u>195,780</u>	<u>4,070</u>	<u>106,364</u>	<u>154,538</u>	<u>460,752</u>

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**Table of Contents****BEN NEDERLAND HOLDING B.V.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

Assets under construction mainly represent costs incurred in the design and construction of the company's network.

**6. RECEIVABLES**

	<u>2001</u>	<u>2000</u>
	<u>000</u>	<u>000</u>
Third party receivables	80,758	79,514
Prepaid expenses	1,034	564
Taxation	1,923	6,064
	<u>83,715</u>	<u>86,142</u>

**7. ISSUED SHARE CAPITAL**

The total authorised share capital consists of 500,000,000 shares each having a nominal value of 0,45 (NLG 1), of which 199,999,998 have been issued and fully paid at December 31, 2001 (2000: 90,756,042).

**8. SHARE PREMIUM ACCOUNT**

	<u>2001</u>	<u>2000</u>
	<u>000</u>	<u>000</u>
Balance at January 1	1,138,781	113,445
Share premium paid on shares issued		1,025,336
Balance at December 31, 2001	<u>1,138,781</u>	<u>1,138,781</u>

**9. ACCUMULATED DEFICIT**

	<u>2001</u>	<u>2000</u>
	<u>000</u>	<u>000</u>
Balance at January 1	(422,122)	(182,743)
Current year net result/(loss)	(198,866)	(239,379)
Balance at December 31	<u>(620,988)</u>	<u>(422,122)</u>

**10. CURRENT LIABILITIES**

	<u>2001</u>	<u>2000</u>
	<b>000</b>	<b>000</b>
Loans from shareholders	379,845	63,276
Trade creditors	112,787	119,120
Accruals and other creditors	23,904	12,000
Tax and social security	9,452	3,076
	<u>525,988</u>	<u>197,472</u>

**11. OPERATING EXPENSES**

	<u>2001</u>	<u>2000</u>
	<b>000</b>	<b>000</b>
Selling and marketing expenses	150,390	128,310
General and administrative expenses	184,617	133,295
Depreciation and amortisation	75,032	54,785
	<u>410,039</u>	<u>316,390</u>

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**Table of Contents****BEN NEDERLAND HOLDING B.V.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE THREE YEARS ENDED DECEMBER 31, 2001****12. REMUNERATION OF DIRECTORS**

The company's directors received remuneration of 874,105 during the year 2001.

**13. EMPLOYEES**

Total employee expenses amounted to 40,940,035 (2000: 30,166,093) including social security of 3,711,361 (2000: 2,645,145) and pension costs of 3,083,489 (2000: 1,883,913). Employee expenses are included in General and administrative expenses.

The group had an average of 1,142 employees during 2001 (2000: 691).

**14. NET FINANCIAL INCOME/(EXPENSE)**

	<u>2001</u>	<u>2000</u>
	<b>000</b>	<b>000</b>
Interest and similar income	985	890
Interest and similar expense	(11,900)	(12,850)
Foreign exchange gain/(loss)	(158)	(493)
Other financial income/(expenses)	783	26
	<u>          </u>	<u>          </u>
	<b>(10,290)</b>	<b>(12,427)</b>
	<b>          </b>	<b>          </b>

Interest expense primarily relates to that payable on shareholder financing.

**15. COMMITMENTS**

At December 31, 2001, the group had entered into various agreements, principally relating to the network, resulting in commitments of 393 million.

The company has issued guarantees under article 403 of the Dutch Civil Code to the group companies Ben Nederland B.V. en Ben Klantenservice B.V.

**16. RECONCILIATION TO U.S. GAAP**

The consolidated financial statements of Ben Nederland Holding B.V. have been prepared in accordance with Dutch GAAP, which differs in certain respects from generally accepted accounting principles in the United States (U.S. GAAP). Application of U.S. GAAP would have affected the balance sheet as of December 31, 2001 and 2000 and the net loss for each of the years in the three-year period ended December 31, 2001 to the extent described below.

**(1) Capitalisation of interest on assets under construction and mobile communication licences**

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- a) Under Dutch GAAP capitalisation of interest accumulated from borrowings during the asset construction period is voluntary. Prior to January 1, 2000, the Company capitalised interest accumulated during the construction period and amortized these costs over the assets useful life. As of January 1, 2000 the company elected to cease capitalization of interest costs related to assets under construction. As part of this change in accounting policy the unamortised balance of 1,795,000 capitalized as of December 31, 1999 was reversed and charged to income in the year 2000.

Under U.S. GAAP, interest accumulated on borrowings during the asset construction period are capitalised and are amortized once the respective assets are placed in operation resulting in an increase in the net loss of 692,000 in 2001 and a decrease in the net loss in 2000 of 4,375,000.

- b) Under Dutch GAAP, interest costs related to the financing of the mobile communications licences are expensed as incurred. Under US GAAP, the license is considered an inextricable part of the network used to provide the actual services and accordingly interest costs related to the financing of the licenses during the network construction period are capitalized as part

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**Table of Contents****BEN NEDERLAND HOLDING B.V.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

of network cost. This results in a decrease in net loss of 11,653,000, 7,754,000 and 379,000 in 2001, 2000 and 1999, respectively.

**(2) Technical equipment lease**

During 1999, the Company entered into a sales lease back transaction relating to certain technical equipment in use by the Company. Under Dutch GAAP, the net cash received was recognized as other operating revenues. Under US GAAP, the gross cash received of 65.6 million and payment liabilities of 61.7 million are recognized on the balance sheet and the net cash gain on the transaction is recognized as other income over the lease term of 16 years.

**(3) Vendor penalties**

During 1998 and 1999 the Company received penalties from a vendor as the vendor failed to meet certain contractual requirements with respect to the roll out of the network. These payments relate to refunds on amounts paid for network assets purchased. Under Dutch GAAP these amounts were recorded as income. Under U.S. GAAP these payments are recorded as a deduction from the cost of the network assets resulting in a reduction of net income and the carrying value of network assets by 13.2 million in 1998 and 4.6 million in 1999. Additionally, depreciation expense related to these assets is reduced by 2.5 million, 2.5 million and 1.2 million for the years ended December 31, 2001, 2000 and 1999, respectively.

The effect of these items is set out in the following tables.

**Reconciliation of net loss from Dutch GAAP to U.S. GAAP:**

(Amounts in 000)

	2001	2000	1999
<b>Net loss as reported in the consolidated financial statements under Dutch GAAP</b>	(198 866)	(239 379)	(162 429)
Interest capitalisation <sup>(1)</sup>	10 961	12 129	379
Technical equipment lease <sup>(2)</sup>	250	250	(3 875)
Vendor penalties <sup>(3)</sup>	2 540	2 540	(3 358)
<b>Net loss in accordance with U.S. GAAP</b>	<b>(185 115)</b>	<b>(224 460)</b>	<b>(169 283)</b>

**Reconciliation of shareholders equity from Dutch GAAP to U.S. GAAP**

(Amounts in 000)

	Dec 31, 2001	Dec 31, 2000
<b>Shareholders equity in accordance with Dutch GAAP</b>	608 549	807 415
Interest capitalisation <sup>(1)</sup>	26 181	15 220
Technical equipment lease <sup>(2)</sup>	(3 375)	(3 625)
Vendor penalties <sup>(3)</sup>	(9 555)	(12 095)
<b>Shareholders equity in accordance with U.S. GAAP</b>	<b>621 800</b>	<b>806 915</b>



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**DT-FT ITALIAN HOLDING GmbH, Bonn**

**CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 2000**

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**REPORT OF INDEPENDENT ACCOUNTANTS**

**To the Board of Management and Shareholders of DT-FT Italian Holding GmbH Bonn:**

We have audited the accompanying balance sheet of DT-FT Italian Holding GmbH, Bonn as of December 31, 2000, and the related statements of income and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DT-FT Italian Holding GmbH, Bonn as of December 31, 2000, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in Germany.

Frankfurt am Main, April 30, 2001

PwC Deutsche Revision

Aktiengesellschaft  
Wirtschaftsprüfungsgesellschaft

(Kütting)	(ppa.Sahorsch)
Wirtschaftsprüfer	Wirtschaftsprüfer

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## DT-FT ITALIAN HOLDING GmbH, BONN

## STATEMENT OF INCOME

	<u>2000</u>
Other operating income	4,617,026,502
Other operating expenses	(13,439)
Interest and similar income	117,757,061
	<hr/>
<b>Results from ordinary business activities</b>	<b>4,734,770,124</b>
Income taxes	(45,311,726)
Other taxes	(15,789,937)
	<hr/>
<b>Annual net income</b>	<b>4,673,668,461</b>
Net operating loss carryforward	(97,345)
	<hr/>
<b>Unappropriated net income</b>	<b>4,673,571,116</b>
	<hr/>

The accompanying notes are an integral part of the consolidated financial statements.

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## DT-FT ITALIAN HOLDING GmbH, BONN

## BALANCE SHEET

	December 31, 2000
<b>Assets</b>	
<b>A. Noncurrent assets</b>	
Financial assets	
1. Subsidiaries & associated companies	_____
	_____
<b>B. Current assets</b>	
I. Receivables and other assets	
1. Other assets	4,861,701,151
II. Cash in banks	627,156,812
	_____
	<b>5,488,857,963</b>
	_____
	<b>5,488,857,963</b>
	_____
<b>Liabilities</b>	
<b>A. Shareholders' equity</b>	
I. Capital stock	25,564
II. Additional paid-in capital	773,394,283
III. Net operating loss carryforward	(97,345)
IV. Income/loss after taxes	4,673,668,461
	_____
	<b>5,446,990,963</b>
	_____
<b>B. Accruals</b>	
1. Tax accruals	41,843,414
2. Other accruals	23,519
	_____
	<b>41,866,933</b>
	_____
<b>C. Liabilities</b>	
1. Trade accounts payable	67
2. Other liabilities	_____
	<b>67</b>
	_____
	<b>5,488,857,963</b>
	_____

The accompanying notes are an integral part of the consolidated financial statements.

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## DT-FT ITALIAN HOLDING GmbH, BONN

## DEVELOPMENT OF NONCURRENT ASSETS

	Acquisition values			Dev. of accumulated write-downs/ depreciation				Remaining book
	01/01/2000	Additions	Disposals	31/12/2000	01/2000	Additions	Disposals	31/12/2000
Financial assets								
1. Investments in unconsolidated subsidiaries	443,990,462	328,983,812	772,974,274	0	0	0	0	0
	<u>443,990,462</u>	<u>328,983,812</u>	<u>772,974,274</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

## DEVELOPMENT OF ACCRUALS

	01/01/2000	Consumption	Reversal	Addition	31/12/2000
Tax accruals					
Corp. income tax & solidarity surcharge	0	0	0	23,117,093	23,117,093
Trade tax	0	0	0	18,726,321	18,726,321
	<u>0</u>	<u>0</u>	<u>0</u>	<u>41,843,414</u>	<u>41,843,414</u>
Other accruals					
Outstanding expenses	10,701	0	476	13,294	23,519
Litigation risks	76,694	76,394	300	0	0
	<u>87,395</u>	<u>76,394</u>	<u>776</u>	<u>13,294</u>	<u>23,519</u>
	<u>87,395</u>	<u>76,394</u>	<u>776</u>	<u>41,856,708</u>	<u>41,866,933</u>

The accompanying notes are an integral part of the consolidated financial statements.

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## DT-FT ITALIAN HOLDING GmbH, BONN

## STATEMENT OF CASH FLOWS

	December 31, 2000
Income after taxes	4,673,668,461
Net interest expense	(117,757,061)
Income tax expense	61,101,664
Book profits from the selling of noncurrent assets	(4,617,025,726)
Other noncash income and expense	
<b>Cashflow before changes in working capital</b>	<b>(12,662)</b>
Increase (-)/decrease in accruals	(63,876)
Increase (-)/decrease in liabilities	(6,038)
	<b>(82,576)</b>
Income tax paid (-)/received	(19,258,250)
Interest paid (-)/received	26,755,910
<b>Net cash provided by operating activities</b>	<b>7,415,084</b>
Net investments in noncurrent assets	(328,983,809)
Proceeds from sale of noncurrent assets	619,300,000
<b>Net cash used for investing activities</b>	<b>290,316,191</b>
Transfer to additional paid-in capital	
In-payments of the shareholders	328,983,045
<b>Net cash provided by (used for) financing activities</b>	<b>328,983,045</b>
<b>Decrease (-) in liquid funds maturing within 3 months</b>	<b>626,714,320</b>
Liquid funds maturing within 3 months (beginning of the year)	442,496
Liquid funds maturing within 3 months (end of the reporting period)	627,156,812
<b>Changes in the amounts of liquid funds maturing within 3 months and in Deutsche Telekom s cash pool</b>	<b>626,714,316</b>

The accompanying notes are an integral part of the consolidated financial statements.

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**DT FT ITALIAN HOLDING GmbH, BONN**

**DECEMBER 31, 2000**

**I. General information and comments**

*Basic principles and methods*

The corporate purpose is to purchase, own and manage WIND Telecomunicazioni S.p.A. shares.

*Accounting and valuation principles*

The annual financial statements of DT FT Italian Holding GmbH have been prepared in accordance with the provisions of the German Commercial Code. The classification of the consolidated statement of income is based on the total cost method of accounting.

The money accounts stated under current assets are verified through statements of account.

The translation of the receivables owed in foreign currency is based on the price valid on the day the transaction is performed or on the lower buying rate on the balance sheet date. The translation of the foreign currency liabilities is based on the price valid on the day the transaction is performed or on the higher selling rate on the balance sheet date.

**II. Notes on the balance sheet and the statement of income**

*Financial assets (see table of consolidated noncurrent assets)*

DT FT Italian Holding GmbH sold and transferred 43% of its Wind shares to FT Participations Belgium S.A. (FTPB) at a price of EUR 4.73 billion and 0.37% of its Wind shares at a price of EUR 40.7 million, effective from 27 July 2000. FTPB and France Telecom S.A. (FT) provided promissory notes in the amount of the purchase price to DT FT Italian Holding GmbH.

In addition, the DT FT Italian Holding GmbH sold 5.63% of its Wind shares to Enel S.p.A. at a price of EUR 619.3 million.

*Other assets*

The other assets consist of interest accruals and deferrals deriving from a EUR 1.5 million fixed-term deposit investment with Deutsche Bank, Bonn and EUR 40.7 million and EUR 4.73 billion in promissory notes from the selling of the Wind shares to FTPB. In addition, this item includes EUR 89 million in promissory notes from the note receivable.

*Liquid funds*

The liquid funds include a EUR 614 million fixed-term deposit investment with Deutsche Bank in Bonn which is based on the selling of the Wind shares to Enel. The credit balance with the banks consists of balances with the Postbank (EUR 21,474) and with Deutsche Bank (EUR 31,189).

*Shareholders equity*

The capital stock remains at Euro 25,565.

*Capital reserves*

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According to the 20 April 2000 resolution of the Shareholders Meeting, the capital stock of WIND Telecomunicazioni S.p.A. was raised from Lit. 889,964,813,000 to Lit. 2,189,964,813,000 through the emission of 1,300,000,000 new ordinary shares at a nominal value of Lira 1,000 each. The value of the payments received from the shareholders was effective from 24 March 2000. 637.00 million shares at a nominal value of EUR 328.00 million go on DT FT Italien Holding GmbH.

### *Accruals*

The accruals include trade income tax (EUR 18.9 million) and the corporate income tax, including the solidarity surcharge (EUR 23 million) as well as accruals for the annual audit (EUR 23,519).

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### ***Liabilities***

The other liabilities relate to notarial charges.

### **Statement of income**

#### ***Other operating income***

The other operating income includes EUR 511 in income from the reversal of accruals and EUR 4.6 billion in income from the selling of the Wind shares.

#### ***Other operating expenses***

The other operating expenses, amounting to EUR 13,294, are costs related to the preparation of the annual financial statements.

#### ***Interest income***

The interest income (EUR 117.6 million) states the interest of the fixed-term deposit investment with the Deutsche Bank and the credit interest of the bank account (EUR 12.3 million). In addition, interest was due for DTFT's claim in connection with FTBP's note receivable from the selling of the WIND shares (EUR 105.3 million). The interest rate is EURIBOR 3 months roll-over plus 0.25%.

#### ***Income taxes***

The income taxes state the corporate income tax (EUR 22 million), the trade income tax (EUR 18.9 million), the solidarity surcharge (EUR 1.5 million) and the capital gains tax (EUR 3 million). The interest due for the claim in connection with the note receivable from FTBP's results in a foreign withholding tax amounting to EUR 15.9 million which is creditable against the corporate income tax.

In the year under review, no compensation was paid for Managing Directors.

### **Statement of Cash Flows**

The statement of cash flows has been prepared in conformity with International Accounting Standard (IAS) 7, Cash Flow Statements. Besides IAS 7, German Accounting Standard (DRS) No. 2, Cash Flow, is used.

#### ***Significant differences between German and United States generally accepted accounting principles***

DT-FT Italian Holding GmbH, Bonn prepares its financial statements in accordance with German GAAP. Significant differences arise from the application of U.S. GAAP as compared to German GAAP. The significant differences are described as follows:

For German GAAP the investment in WIND Telecomunicazioni S.p.A. ( WIND ) is accounted for at cost. For U.S. GAAP the investment would be accounted for using the equity method, which requires that the DT-FT's percentage of the losses of WIND are recorded in the income statement. This accounting would reduce the investment balance in WIND, thus increasing the gain on the sale of WIND. In addition, U.S. GAAP would require significant disclosures related to the WIND investment.

### **1. Management**

Wolfgang Kaiser

*Corporate legal adviser*

Bonn

Philippe McAllister

*Corporate legal adviser*  
Paris

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**OJSC MOBILE TELESYSTEMS**

**AND SUBSIDIARIES**

**Consolidated Financial Statements**

**December 31, 2002 and 2001**

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**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

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**INDEPENDENT AUDITOR S REPORT**

To the Shareholders of OJSC Mobile TeleSystems:

We have audited the accompanying consolidated balance sheets of Mobile TeleSystems, a Russian Open Joint-Stock Company, and subsidiaries (the Group) as of December 31, 2002 and 2001, and the related consolidated statements of operations, cash flows and shareholders' equity for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Mobile TeleSystems and its subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 4 to the consolidated financial statements, the Group changed its method of accounting for subscriber acquisition costs in 2001.

Moscow, Russia

May 20, 2003, except for Note 26, as to which the date is June 4, 2003

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## Consolidated Balance Sheets

at December 31, 2001 and 2002

(Amounts in thousands of U.S. dollars, except share amounts)

	December 31	
	2001	2002
<b>Current Assets:</b>		
Cash and cash equivalents (Note 7)	\$ 219,629	\$ 34,661
Short-term investments (Note 8)	85,304	30,000
Trade receivables, net (Note 9)	24,258	40,501
Accounts receivable, related parties (Note 20)	2,377	3,569
Inventory (Note 10)	26,184	41,386
Prepaid expenses	22,712	26,537
Deferred tax asset, current portion (Note 17)	5,802	12,223
VAT receivable	82,216	154,061
Other current assets	8,374	15,392
<b>Total current assets</b>	<b>476,856</b>	<b>358,330</b>
<b>Property, Plant and Equipment</b> , net of accumulated depreciation of \$168,989 and \$299,216, respectively (Note 11)	856,056	1,344,633
<b>Licenses</b> , net of accumulated amortization of \$100,429 and \$143,402, respectively (Notes 6 and 23)	298,827	386,919
<b>Other Intangible Assets</b> , net of accumulated amortization of \$52,953 and \$78,889, respectively (Note 12)	84,778	138,090
<b>Debt Issuance Costs</b> , net of accumulated amortization of \$1,209 and \$2,898, respectively (Note 14)	3,997	2,957
<b>Investments in and Advances to Affiliates</b> (Note 22)	740	34,034
<b>Deferred Tax Asset</b> , net of current portion (Note 17)	6,238	18,333
<b>Total assets</b>	<b>\$1,727,492</b>	<b>\$2,283,296</b>

The accompanying notes to financial statements are an integral part of these statements.

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## Consolidated Balance Sheets

at December 31, 2001 and 2002 (Continued)  
(Amounts in thousands of U.S. dollars, except share amounts)

	December 31	
	2001	2002
<b>CURRENT LIABILITIES:</b>		
Accounts payable, related parties (Note 20)	\$ 6,142	\$ 4,968
Trade accounts payable	106,068	117,623
Deferred connection fees, current portion (Note 13)	21,419	22,210
Subscriber prepayments and deposits	63,741	110,950
Debt, current portion (Note 14)	18,825	67,098
Capital lease obligation, current portion (Notes 15 and 20)	14,401	21,232
Income tax payable	23,078	3,987
Accrued liabilities (Note 16)	51,626	73,919
Other payables	3,357	2,225
<b>Total current liabilities</b>	<b>308,657</b>	<b>424,212</b>
<b>LONG-TERM LIABILITIES:</b>		
Notes payable (Note 14)	248,976	300,638
Debt, net of current portion (Note 14)	35,942	58,276
Capital lease obligation, net of current portion (Notes 15 and 20)	7,696	7,241
Deferred connection fees, net of current portion (Note 13)	25,993	19,694
Deferred taxes (Note 17)	67,505	105,818
<b>Total long-term liabilities</b>	<b>386,112</b>	<b>491,667</b>
<b>Total liabilities</b>	<b>694,769</b>	<b>915,879</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
(Note 24)		
<b>MINORITY INTEREST</b>	14,444	65,373
<b>SHAREHOLDERS EQUITY:</b>		
Common stock: (2,096,975,792 shares with a par value of 0.1 rubles authorized and 1,993,326,138 shares issued as of December 31, 2001 and 2002, 345,244,080 of which are in the form of ADS (Note 1))	50,558	50,558
Treasury stock (9,966,631 common shares at cost) (Note 19)	(10,206)	(10,206)
Additional paid-in capital	555,794	558,102
Unearned compensation (Note 19)		(212)
Shareholder receivable (Note 14)	(38,958)	(34,412)
Retained earnings	461,091	738,214
<b>Total shareholders equity</b>	<b>1,018,279</b>	<b>1,302,044</b>



<b>Total liabilities and shareholders equity</b>	<b>\$1,727,492</b>	<b>\$2,283,296</b>
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The accompanying notes to financial statements are an integral part of these statements.

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**Table of Contents****OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES****Consolidated Statements of Operations****for the Years Ended December 31, 2000, 2001 and 2002****(Amounts in thousands of U.S. dollars, except share and per share amounts)**

	2000	2001	2002
<b>NET REVENUES:</b>			
Service revenues	\$ 484,469	\$ 830,308	\$ 1,274,287
Connection fees	14,885	21,066	24,854
Equipment sales	36,358	41,873	62,615
	<u>535,712</u>	<u>893,247</u>	<u>1,361,756</u>
<b>COST OF SERVICES AND PRODUCTS</b> (including related party amounts of \$20,040, \$30,537 and \$31,607, respectively):			
Interconnection and line rental	41,915	75,278	113,052
Roaming expenses	41,178	68,387	83,393
Cost of equipment	39,217	39,828	90,227
	<u>122,310</u>	<u>183,493</u>	<u>286,672</u>
<b>OPERATING EXPENSES</b> (including related party amounts of \$5,064, \$8,882 and \$9,602, respectively) (Note 21):	110,242	134,598	229,056
<b>SALES AND MARKETING EXPENSES</b> (including related party amounts of \$6,400, \$8,707 and \$12,140, respectively):			
	76,429	107,729	171,977
<b>DEPRECIATION AND AMORTIZATION</b>	87,684	133,318	209,680
<b>IMPAIRMENT OF INVESTMENT</b> (Note 22)		10,000	
<b>Net operating income</b>	<u>139,047</u>	<u>324,109</u>	<u>464,371</u>
<b>CURRENCY EXCHANGE AND TRANSLATION LOSSES</b>	1,066	2,264	3,474
<b>OTHER EXPENSES (INCOME)</b> (including related party amounts of \$952, \$2,978 and \$5,141, respectively):			
Interest income (Note 8)	(7,626)	(11,829)	(8,289)
Interest expense, net of amounts capitalized	11,335	6,944	44,389
Other (income) expense, net	(502)	108	(2,454)
Total other expenses (income), net	3,207	(4,777)	33,646
<b>Income before provision for income taxes and minority interest</b>	134,774	326,622	427,251
<b>PROVISION FOR INCOME TAXES</b> (Note 17)			
	51,154	97,461	110,417
<b>MINORITY INTEREST</b>	(6,428)	7,536	39,711

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<b>NET INCOME</b> before cumulative effect of a change in accounting principle and extraordinary gain	90,048	221,625	277,123
Extraordinary gain on debt repayment, net of income taxes of \$667 (Note 14)		2,113	
Cumulative effect of a change in accounting principle, net of income taxes of \$9,644 (Note 4)		(17,909)	
<b>NET INCOME</b>	<b>\$ 90,048</b>	<b>\$ 205,829</b>	<b>\$ 277,123</b>
Weighted average number of common shares outstanding	1,806,968,096	1,983,359,507	1,983,359,507
Earnings per share basic and diluted:			
Net income before cumulative effect of a change in accounting principle and extraordinary gain	\$ 0.050	\$ 0.112	\$ 0.140
Net income	\$ 0.050	\$ 0.104	\$ 0.140

The accompanying notes to financial statements are an integral part of these statements.

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## Consolidated Statements of Shareholders' Equity

for the Years Ended December 31, 2000, 2001 and 2002  
(Amounts in thousands of U.S. dollars, except share amounts)

	Common Stock		Treasury Stock		Additional Paid-in Capital	Unearned Compen- sation	Share- holder Receivable	Retained Earnings	Total
	Shares	Amount	Shares	Amount					
<b>BALANCES, December 31, 1999</b>	<b>1,634,527,440</b>	<b>\$49,276</b>			<b>\$182,975</b>		<b>\$(70,331)</b>	<b>\$181,804</b>	<b>\$ 343,724</b>
Receivable from Sistema (Note 14):									
Increases for interest					6,268		(6,268)		
Payments from Sistema							27,080		27,080
Issuance of common shares, net of direct expenses (Note 1)	345,244,080	1,233			347,320				348,553
Purchase of treasury stock under the stock bonus plan (Note 19)	13,554,618	49	(13,554,618)	(13,880)	13,831				
Exercise of stock bonus plan (Note 19)			3,587,987	3,674	(3,661)				13
Non-cash expense associated with issuance of stock bonus (Note 19)					5,297				5,297
Net income							90,048		90,048
Dividends declared							(13,631)		(13,631)
<b>BALANCES, December 31, 2000</b>	<b>1,993,326,138</b>	<b>50,558</b>	<b>(9,966,631)</b>	<b>(10,206)</b>	<b>552,030</b>		<b>(49,519)</b>	<b>258,221</b>	<b>801,084</b>
Receivable from Sistema (Note 14):									
Increases for interest					3,764		(3,764)		
							14,325		14,325

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Payments from Sistema									
Net income							205,829	205,829	
Dividends declared							(2,959)	(2,959)	
<b>BALANCES, December 31, 2001</b>									
	<b>1,993,326,138</b>	<b>50,558</b>	<b>(9,966,631)</b>	<b>(10,206)</b>	<b>555,794</b>		<b>(38,958)</b>	<b>461,091</b>	<b>1,018,279</b>
Receivable from Sistema (Note 14):									
Increases for interest					2,073		(2,073)		
Payments from Sistema							6,619	6,619	
Issuance of stock options (Note 19)					235	(235)			
Amortization of deferred compensation (Note 19)							23	23	
Net income							277,123	277,123	
<b>BALANCES, December 31, 2002</b>									
	<b>1,993,326,138</b>	<b>\$50,558</b>	<b>(9,966,631)</b>	<b>\$(10,206)</b>	<b>\$558,102</b>	<b>\$(212)</b>	<b>\$(34,412)</b>	<b>\$738,214</b>	<b>\$1,302,044</b>

The accompanying notes to financial statements are an integral part of these statements.

Table of Contents**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

**for the Years Ended December 31, 2000, 2001 and 2002**  
**(Amounts in thousands of U.S. dollars, except share amounts)**

	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 90,048	\$ 205,829	\$ 277,123
Adjustments to reconcile net income to net cash provided by operating activities:			
Minority interest	(6,428)	7,536	39,475
Depreciation and amortization	87,684	133,318	209,680
Amortization of deferred connection fees	(14,867)	(20,027)	(24,854)
Deferred subscriber acquisition cost	(49,232)		
Amortization of deferred subscriber acquisition costs	53,604		
Cumulative effect of a change in accounting principle		17,909	
Gain on debt extinguishments		(2,113)	
Inventory obsolescence expense	2,114	2,543	5,614
Provision for doubtful accounts	2,403	3,219	7,047
Interest accrued	11,335	5,845	44,388
Interest paid	(17,850)	(4,068)	(43,438)
Deferred taxes	(932)	(40,631)	(18,989)
Non-cash expenses associated with stock bonus and stock option plans	5,297		23
Impairment of investment		10,000	
Changes in operating assets and liabilities:			
Decrease/(Increase) in trade receivables	6,730	(7,181)	(18,945)
Decrease/(Increase) in accounts receivable, related parties	4,223	(3,091)	(1,360)
Increase in inventory	(8,922)	(4,129)	(18,186)
Increase in prepaid expenses	(1,680)	(8,552)	(2,634)
Increase in VAT receivable	(6,033)	(59,618)	(64,154)
(Increase)/Decrease in other current assets	(7,363)	1,613	(7,422)
Increase in accounts payable, related parties	743	1,049	81
(Decrease)/Increase in trade accounts payable	(29,801)	20,470	(16,058)
Increase in subscriber prepayments and deposits	43,382	49,980	46,064
Increase/(Decrease) in income tax payable	19,787	10,753	(19,778)
Increase in accrued liabilities and other payables	6,672	17,547	19,095
	<u>190,914</u>	<u>338,201</u>	<u>412,772</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Acquisitions of subsidiaries, net of cash acquired	(16,085)	(75,858)	(143,396)
Purchases of property, plant and equipment	(194,983)	(396,667)	(502,054)
Purchases of intangible assets	(29,915)	(44,533)	(72,218)
Purchases of short term investments	(170,000)	(110,000)	
Proceeds from sale of short term investments		195,602	55,304

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Investments in and advances to affiliates	<u>(12,366)</u>	<u>(10,067)</u>	<u>(35,557)</u>
Net cash used in investing activities	<u>(423,349)</u>	<u>(441,523)</u>	<u>(697,921)</u>

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

for the Years Ended December 31, 2000, 2001 AND 2002 (Continued)

(Amounts in thousands of U.S. dollars, except share amounts)

	2000	2001	2002
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of capital stock, net of direct expenses	348,553		
Proceeds from issuance of notes		248,135	50,808
Notes issuance cost		(3,856)	(649)
Capital lease obligation principal paid		(7,947)	(1,804)
Dividends paid	(14,425)	(2,959)	
Proceeds from loans		13,577	52,851
Loan principal paid	(62,665)	(13,683)	(7,008)
Payments from Sistema	27,080	14,325	6,619
	<u>298,543</u>	<u>247,592</u>	<u>100,817</u>
Effect of exchange rate changes on cash and cash equivalents	(280)	(469)	(636)
	<u>65,828</u>	<u>143,801</u>	<u>(184,968)</u>
<b>CASH AND CASH EQUIVALENTS, at beginning of year</b>	<b>10,000</b>	<b>75,828</b>	<b>219,629</b>
<b>CASH AND CASH EQUIVALENTS, at end of year</b>	<b>\$ 75,828</b>	<b>\$ 219,629</b>	<b>\$ 34,661</b>
<b>SUPPLEMENTAL INFORMATION:</b>			
Income taxes paid	\$ 35,052	\$ 129,418	\$ 147,346
Additions to network equipment and software under capital lease	\$	\$ 34,072	\$ 18,917

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**Table of Contents****OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

**1. GENERAL*****Business of the Group***

OJSC Mobile TeleSystems and its subsidiaries ( MTS or the Group ) is the leading provider of wireless telecommunication services in the Russian Federation ( RF ) in terms of the number of subscribers and revenues. The Group has operated exclusively in the GSM standard since 1994 and as of December 31, 2002, had over 6.6 million subscribers in the Russian Federation.

Open Joint-Stock Company Mobile TeleSystems ( MTS OJSC or the Company ) was created on March 1, 2000, through the merger of Closed Joint-Stock Company Mobile TeleSystems ( MTS CJSC ) and RTC CJSC, a wholly-owned subsidiary. MTS CJSC was formed in 1993 to design, construct and operate a cellular telecommunications network in Moscow and the Moscow region. The development of the network was achieved through green-field build-out in the regions for which the company was granted 900 or 1800 MHz ( GSM-900 and GSM-1800 ) cellular licenses or through the acquisition of a majority stakes in local GSM operators (see Note 23 Operating Licenses and Note 6 Businesses Acquired).

***Reorganization***

In March 2000, MTS CJSC was merged with RTC CJSC, to create MTS OJSC. This corporate merger has been accounted for at historical cost in a manner similar to that in pooling of interest accounting because the merged companies were entities under common control.

The accompanying consolidated financial statements represent those of Open-Joint-Stock Company Mobile TeleSystems and its legal predecessor, Closed Joint-Stock Company Mobile TeleSystems. Shares, earnings per share and other share information have been restated in the accompanying consolidated financial statements to give retroactive effect to the capital structure of MTS OJSC.

***Initial Public Offering***

In July 2000, MTS OJSC issued additional shares in an initial public offering on the New York Stock Exchange. The Company's shares are traded in the form of American Depositary Shares ( ADS ). Each ADS represents 20 shares of common stock of the Company. The Company issued a total of 17,262,204 ADS, representing 345,244,080 common shares in the offering. Proceeds from the offering, net of underwriting discount, were \$349 million (see also Note 19 Management Stock Bonus and Stock Option Plans).

***Ownership***

As of December 31, 2001 and 2002, MTS's shareholders of record and their respective percentage direct interests were as follows:

Joint-Stock Financial Corporation - Sistema ( Sistema )	34.8%
T-Mobile International AG ( T-Mobile )	36.2%
VAST, Limited Liability Company ( VAST )	3.0%

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Invest-Svyaz-Holding, Closed Joint-Stock Company	8.0%
ADS Holders	18.0%
	<hr/>
	<b>100.0%</b>
	<hr/>

Sistema owns 51% equity interest in VAST, a limited liability company incorporated under the laws of the Russian Federation; the remaining 49% interest is held by ASVT, a Russian open joint-stock company. Invest-Svyaz-Holding, a closed joint-stock company incorporated under the laws of the Russian Federation, is controlled by Sistema through a 51% equity interest. The remaining 49% interest is owned by T-Mobile.

Subsequently to December 31, 2002, Sistema increased its share in MTS through a series of transactions with T-Mobile.

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

**2. RUSSIAN ENVIRONMENT**

Over the past decade Russia has undergone substantial political, economic and social changes. As an emerging market, Russia does not possess a fully developed business and regulatory infrastructure that would generally exist in a more mature market economy. The current government is attempting to address these issues; however, it has not yet fully implemented the reforms necessary to create banking, judicial and regulatory systems that usually exist in more developed markets. As a result, and as reflected in the government's debt default and the ruble devaluation in 1998, operations in Russia involve risks that are not typically associated with those in developed markets. Such risks persist in the current environment with results that include but are not limited to, a currency that is not freely convertible outside of the country, various currency controls, low liquidity levels for debt and equity markets, and continuing inflation. Foreign currencies, in particular the U.S. dollar, play a significant role in the underlying economics of many business transactions in Russia. Following the 1998 economic crisis, the ruble's value fell significantly against the U.S. dollar, falling from a pre-crisis rate of approximately 6 rubles to 1 U.S. dollar, to 27 rubles to 1 U.S. dollar by the end of 1999. During 2000, 2001 and 2002, the ruble's value fluctuated between 26.9 and 31.8 to 1 U.S. dollar.

***Currency Exchange and Control***

The Central Bank of Russia has established strict currency control regulations designed to promote the commercial utilization of the ruble. Such regulations place restrictions on the conversion of rubles into foreign currencies and establish requirements for conversion of foreign currency sales into rubles. MTS's principal currency exchange rate risk arises from the fact that the majority of cash outflows as well as debt and accounts payable balances are either denominated in or tightly linked to the U.S. dollar. As a result, devaluation of the ruble against the U.S. dollar can adversely affect the Group by increasing its costs in ruble terms. In order to manage against this risk, the Group links its tariffs, which are payable in rubles, to the U.S. dollar. The devaluation of the ruble also results in losses in the value of ruble-denominated assets, such as ruble deposits. These losses, which are included in currency exchange and translation losses in the accompanying consolidated statements of operations, were approximately \$1.1 million in 2000, \$2.3 million in 2001 and \$3.5 million in 2002. Continued devaluation of the ruble against the U.S. dollar may have a significant negative effect on the Group's financial position and results of its operations.

***Inflation***

The Russian economy has been characterized by high rates of inflation. The following table summarizes the annual rate of inflation for the past three years:

	<b>Annual Inflation</b>
2002	15.1%
2001	18.6%
2000	20.2%

The Group's principal inflation rate risk arises in connection with the probable decrease of sales resulting from a decrease of customers' demand, as the Group's services may become expensive and exclusive. As substantially all of the Group's costs are denominated in U.S. dollars or are tightly linked to the U.S. dollar, when the rate of inflation exceeds the rate of devaluation of the ruble against the U.S. dollar, the Group can experience inflation-driven increases in dollar terms of certain of its costs. These include salaries and rents, which are

sensitive to rises in the general price level in Russia. In this situation, due to competitive pressures, the Group may not be able to raise its tariffs sufficiently to preserve operating margins. Accordingly, high rates of inflation relative to the rate of devaluation could increase the Group's costs and decrease the Group's operating margins.

Management is unable to estimate what developments may occur or the resulting effect of any such developments on MTS' financial condition or future results of operations. MTS will continue to be affected,

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for the foreseeable future, by the country's unstable economy. The consolidated financial statements do not include any adjustment that may result from these uncertainties.

***Taxation***

Russia currently has a number of laws related to various taxes imposed by both federal and regional governmental authorities. Applicable taxes include value added tax ( VAT ), corporate income tax (profits tax), a number of turnover-based taxes, and payroll (social) taxes, together with others. Laws related to these taxes have not been in force for significant periods, in contrast to more developed market economies; therefore, the government's implementation of these regulations is often inconsistent or nonexistent. Accordingly, few precedents with regard to tax rulings have been established. Tax declarations, together with other legal compliance areas (for example, customs and currency control matters), are subject to review and investigation by a number of authorities, which are enabled by law to impose extremely severe fines, penalties and interest charges. These facts create tax risks in Russia substantially more significant than typically found in countries with more developed tax systems.

In recent years, the Russian government has initiated revisions of the Russian tax system. Effective January 1, 1999, the first part of the Tax Code was enacted. Effective January 1, 2001, the second part of the Tax Code was enacted and effective January 1, 2002 new regulations, relating to federal income tax were enacted. The new tax system is generally intended to reduce the number of taxes, the overall tax burden on businesses, and to simplify the tax laws.

Generally, tax declarations remain open and subject to inspection for a period of three years following the tax year. As of December 31, 2002, substantially all of the tax declarations of the Group for the preceding three years were open to further review.

Management believes that it has adequately provided for tax liabilities in the accompanying consolidated financial statements; however, the risk remains that relevant authorities could take differing positions with regard to interpretive issues and the effect could be significant.

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Accounting principles***

MTS maintains its accounting books and records in Russian rubles based on Russian accounting regulations. The accompanying consolidated financial statements have been prepared in order to present MTS financial position and its results of operations and cash flows in accordance with accounting principles generally accepted in the United States ( U.S. GAAP ) and expressed in terms of U.S. dollars.

***Basis of presentation***

The accompanying consolidated financial statements include the accounts of MTS OJSC and its wholly owned and majority owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

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As of December 31, 2001 and 2002, MTS has investments in the following legal entities:

	Accounting Method	December 31	
		2001	2002
Rosico	Consolidated	100.0%	100.0%
ReCom	Consolidated	53.9%	53.9%
MTS-Komi Republic ( MTS-RK )	Equity	26.0%	26.0%
MTS-Kostroma	Equity	26.0%	26.0%
MTS-Tver ( MTS-T )	Equity	26.0%	26.0%
UDN-900	Consolidated	51.0%	51.0%
ACC	Consolidated	100.0%	100.0%
MSS	Consolidated	83.5%	83.5%
MTS-Nizhny Novgorod ( MTS-NN )	Consolidated	65.0%	65.0%
Telecom XXI	Consolidated	100.0%	100.0%
Telecom-900	Consolidated	81.0%	100.0%
Novitel	Consolidated	51.0%	51.0%
MTS Finance <sup>(1)</sup>	Consolidated	100.0%	100.0%
BM-Telecom	Consolidated		100.0%
MTS Belarus	Equity		49.0%
MTS-P	Consolidated		51.0%
Kuban-GSM	Consolidated		52.7%
Dontelecom	Consolidated		100.0%
Mobicom-Barnaul	Consolidated		100.0%
BIT	Consolidated		100.0%

(1) Represents beneficial ownership.

**Translation methodology**

Translation (re-measurement) of MTS ruble denominated financial statements into U.S. dollars has been performed in accordance with the provisions of Statement of Financial Accounting Standard ( SFAS ) No. 52 Foreign currency translation, as they relate to hyperinflationary economies.

Monetary assets and liabilities have been translated at the period-end exchange rates. Non-monetary assets and liabilities have been translated at historical rates. Revenues, expenses and cash flows have been translated at historical rates. Translation differences resulting from the use of these rates have been accounted for as currency translation gains and losses in the accompanying consolidated statements of operations.

Effective January 1, 2003, Russian economy ceased to be considered hyperinflationary, however management believes that U.S. dollar will still be the appropriate functional currency due to pervasive use of the dollar in the Group's operations.

**Management estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and

expenses during the reporting period. Actual results could differ from those estimates.

*Cash and cash equivalents*

Cash represents cash on hand and in MTS bank accounts and short-term investments having original maturities of less than three months.

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***Short-term investments***

Short-term investments represent investments in time deposits, which have original maturities in excess of three months but less than twelve months. These investments are being accounted for at cost.

***Allowance for doubtful accounts***

MTS provides an allowance for doubtful accounts based on management's periodic review of accounts receivable from customers and other receivables.

***Prepaid expenses***

Prepaid expenses are primarily comprised of advance payments made for inventory and services to vendors.

***Inventory***

Inventory, accounted for at lower of cost, determined by the first-in, first-out, or FIFO method, or market, consists of telephones, accessories and spare parts for equipment.

Inventories are written down to their market values based on specific monthly reviews of significant inventoried items and expensed as cost of services and products.

***Value-added taxes***

Value-added taxes related to sales are payable to the tax authorities on an accrual basis based upon invoices issued to the subscriber. VAT incurred for purchases may be reclaimed, subject to certain restrictions, against VAT related to sales.

VAT related to purchase transactions that are not currently reclaimable as of the balance sheet dates are recognized in the balance sheets on a gross basis.

***Property, plant and equipment***

Property, plant and equipment with a useful life of more than one year is capitalized at historical cost and depreciated on a straight-line basis over their expected useful lives as follows:

Network and base station equipment	5 – 12 years
Leasehold improvements	shorter of 10 years or lease term
Office equipment and computers	5 years
Buildings	50 years
Vehicles	4 years

Construction in progress and equipment held for installation are not depreciated until the constructed or installed asset is ready for its intended use.



Maintenance and repair costs are expensed as incurred; while upgrades and improvements are capitalized. MTS capitalizes interest costs with respect to qualifying construction projects.

*License costs*

License costs are capitalized as a result of (a) purchase price allocated to licenses acquired in business combinations (see Note 6 Business Acquired) and (b) licenses granted directly from government organizations, which require license payments.

As the Group and the industry do not have sufficient experience with the renewal of licenses, license costs are being amortized, subject to periodic review for impairment, on the straight-line basis over the term of the license commencing from the date such license area becomes commercially operational.

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Upon adoption of SFAS No. 142, Goodwill and Other Intangible Assets on January 1, 2002, the Group reclassified \$22 million relating to the 1998 acquisition of Rosico from goodwill to licenses.

***Other intangible assets***

Intangible assets represent various purchased software costs, telephone numbering capacity, acquired customer base and rights to use premises. A significant portion of the rights to use premises was contributed by shareholders to the Group's charter capital. Deferred telephone numbering capacity costs with limited contractual life are being amortized over five to ten years and the rights to use premises are being amortized over ten years. Telephone numbering capacity with limited contractual life is amortized over its contractual term of five to ten years. Telephone numbering capacity with unlimited contractual life is not amortized, but is reviewed, at least annually, for impairment in accordance with the provisions of SFAS No. 142, Goodwill and Other Intangible Assets. Amortization of deferred numbering capacity costs starts immediately upon the purchase of numbering capacity. Software costs are amortized over four years. Acquired customer base is amortized over the estimated average subscriber life. Other intangible assets are being amortized over three to four years. All finite-life intangible assets are being amortized using the straight-line method.

***Leasing arrangements***

The Group accounts for leases based on the requirements of SFAS No. 13, Accounting for Leases. Certain subsidiaries of the Group lease operating facilities, which include switches, base stations and other cellular network equipment as well as billing systems. The present value of future minimum lease payments at the inception of the lease which is classified as a capital lease is reflected as a liability in the balance sheet. Amounts due within one year are classified as short-term liabilities and the remaining balance as long-term liabilities. The interest rate implicit in the leases varies from 4% to 44% (see Note 15 Capital Lease Obligations).

***Subscriber acquisition costs***

Subscriber acquisition costs represent the direct costs paid for each new subscriber enrolled through MTS independent dealers. MTS expenses these costs as incurred. Prior to 2001, these costs were capitalized to the extent of any revenues that had been deferred from the acquisition of a subscriber, such as connection fees charged to a subscriber to initiate call service, and amortized as a component of sales and marketing expense on a straight-line basis over the estimated average subscriber life (see also Note 4 Change in Accounting Principle).

***Investments***

Beginning in 1998, MTS has acquired interests in several Russian legal entities, engaged in telecommunications activity. Investments in entities where MTS holds 20% to 50% and can exercise significant influence but not control are accounted for using the equity method. All investments have been made in companies that are not traded in open markets. Management periodically assesses the realizability of the carrying values of the investments and if necessary records impairment losses to write the investment down to fair value. During the years ended December 31, 2000, 2001 and 2002, management believes that no such impairments have occurred, except as discussed in Note 22 Investments In and Advances to Affiliates.

***Debt issuance costs***

Debt issuance costs are amortized using the effective interest method over the terms of the related loans.

***Impairment of long-lived assets***

MTS periodically evaluates the recoverability of the carrying amount of its long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Whenever events or changes in circumstances indicate that the carrying amounts of those assets may not be recoverable, MTS will compare undiscounted net cash flows estimated to be generated by those assets to the carrying amount of those assets. When these undiscounted cash flows are less than the carrying amounts of

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**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

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the assets, MTS will record impairment losses to write the asset down to fair value, measured by the estimated discounted net future cash flows expected to be generated from the use of the assets. Management believes that during the years ended December 31, 2000, 2001 and 2002, no such impairments have occurred, except as discussed in Note 22 Investments In and Advances to Affiliates.

***Subscriber prepayments***

The Group requires the majority of its customers to pay in advance for telecommunication services. All amounts received in advance of service provided are recorded as a subscriber prepayment liability and are not recorded as revenues until the related services have been provided to the subscriber.

***Revenue recognition***

Revenues are recognized on an accrual basis, when the goods and services are actually provided regardless of when the resulting monetary or financial flow occurs.

MTS categorizes the revenue sources in the statements of operations as follows:

*Service revenues:* (a) subscription fees, (b) usage charge, (c) value added service fees, (d) roaming fees charged to other operators for guest roamers utilizing MTS network and (e) prepaid phone cards.

Connection fees.

*Equipment sales:* (a) sales of handsets and (b) sales of accessories.

***Subscription fees***

MTS recognizes revenues related to the monthly network fees in the month that the wireless service is provided to the subscriber.

***Usage charges and Value added services fees***

Usage charges consist of fees based on airtime used by the caller, the destination of the call and the service utilized.

Value added services fees are based on usage of airtime or volume of data transmitted for value added services, such as short message services, internet usage and data services. MTS recognizes revenues related to usage charges and value added services in the period when services were rendered.

***Roaming fees***

MTS charges roaming per-minutes fees to other wireless operators for non-MTS subscribers utilizing MTS network. Guest roaming fees were \$43,214, \$52,639 and \$83,393 for the years ended December 31, 2000, 2001 and 2002, respectively.

***Pre-paid phone cards***

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MTS sells to subscribers pre-paid phone cards, separately from the handset. These cards allow subscribers to make a predetermined allotment of wireless phone calls and/or take advantage of other services offered by the Group, such as short messages and sending or receiving faxes.

At the time that the pre-paid phone card is purchased, MTS records the receipt of cash as a subscriber deposit. The Group recognizes revenues from the phone cards in the period when subscriber uses time under the phone card. Unused time on sold phone cards is not recognized as revenues until the related services have been provided to the subscriber or the pre-paid phone card has expired.

In 2002 MTS introduced a new line of pre-paid service tariff plans, whereby a customer may purchase a package that allows a connection to the MTS network and a predetermined allotment of wireless phone calls

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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and/or other services offered by the Group. Revenues under these plans are allocated between connection fees and service fees based on their relative fair values.

*Connection fees*

MTS defers initial connection fees from the moment of initial signing of the contract with subscribers over the estimated average subscriber life. The Group estimates that the average expected term of the subscriber relationship is three and one quarter years (see also Note 13 Deferred Connection Fees).

*Equipment sales*

MTS sells handsets and accessories to customers who are entering into contracts for service and as separate distinct transactions. The Group recognizes revenues from the handsets and accessories upon the delivery to the customer, regardless of whether the customer concurrently enters into a service contract, as these contracts do not require the customer to maintain future services with MTS. MTS records estimated returns as a direct reduction of sales at the time the related sales are recorded.

*Expense recognition*

Expenses incurred by MTS in relation to the provision of wireless communication services relate to interconnection and line rental costs, roaming expenses, costs of handsets and other accessories sold, depreciation and amortization and maintenance of the network.

Calls made by subscribers from areas outside of territories covered by the Group licenses are subject to roaming fees charged by the wireless provider in those territories. These roaming charges are recorded as air time revenues on a gross basis, with the related roaming charges being recorded as operating expense, as MTS acts as the principal in the transaction with the subscriber and bears the risk of non-collection from the subscriber.

The costs of handsets and accessories, whether sold to subscribers through the distribution channel or as part of the service contract, are expensed at the initial delivery of equipment to the customer. Any fees paid to dealers in commissions are recorded as a component of sales and marketing expenses.

*Taxation*

Deferred tax assets and liabilities are recognized for the expected future tax consequences of existing differences between financial reporting and tax reporting bases of assets and liabilities, and loss or tax credit carryforwards using enacted tax rates expected to be in effect at the time these differences are realized. Valuation allowances are recorded for deferred tax assets for which it is more likely that these assets will not be realized.

*Advertising costs*

Advertising costs are expensed as incurred. Advertising costs for the years ended December 31, 2000, 2001 and 2002 were \$22,218, \$42,715 and \$48,624, respectively, and are reflected as a component of sales and marketing expenses in the accompanying consolidated statements of operations.

*Earnings per share*

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Basic earnings per share ( EPS ) have been determined using the weighted average number of shares outstanding during the year. Diluted EPS reflect the potential dilution of stock options, granted to employees. There are 4,648,421 stock options outstanding as of December 31, 2002. Earnings and other per share information have been restated to give retroactive effect to the merger of MTS CJSC and RTC CJSC in 2000 (see Note 1 General).

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

The net income component of the diluted EPS equals the reported net income of the Group. The following is the reconciliation of the share component for basic and diluted EPS with respect to the Group's net income:

	December 31	
	2001	2002
Weighted average number of common share outstanding	1,983,359,507	1,983,359,507
Dilutive effect of stock options	30,133	405,946
Weighted average number of common shares and potential shares outstanding	1,983,389,640	1,983,765,453

***Fair value of financial instruments***

The fair market value of financial instruments, consisting of cash and cash equivalents, accounts receivable and accounts payable, which are included in current assets and liabilities, approximates the carrying value of these items due to the short term nature of these amounts. Based on the borrowing rates currently available to the Group for debt with similar terms and average maturities of the outstanding debt, at December 31, 2001 and 2002, the fair value of long-term debt approximated its carrying amount. The fair value of variable rate debt is equivalent to carrying value.

It is not practical to determine the fair value of MTS receivable from Sistema and advances to affiliates, due to the instability of the Russian economy and its effect on interest rates appropriate for determining fair value.

***Comprehensive income***

Comprehensive income is defined as net income plus all other changes in net assets from non-owner sources. For the years ended December 31, 2000, 2001 and 2002, comprehensive income equaled net income.

***Comparative information***

Certain prior year amounts have been reclassified to conform to the current year presentation.

***Stock-based compensation***

MTS accounts for stock options issued to employees, non-employee directors and consultants following the requirements of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148 Accounting for Stock Based Compensation Transition and Disclosure, an amendment to FASB Statement No. 123. These statements allow measuring compensation to employees and non-employee directors based on the intrinsic value of options on the measurement date, calculated as a difference between the fair market value of stock and exercise price at that date. Compensation to consultants is measured based on the fair value of options on the measurement date as determined using a Black-Scholes option-pricing model.





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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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If the Group had elected to recognize compensation costs based on the fair values of options at the date of the grant, consistent with the provisions of SFAS No. 123, net income and earning per share amounts would have been as follows:

	December 31		
	2000	2001	2002
Net income as reported	\$ 90,048	\$ 205,829	\$ 277,123
Pro-forma effect of the application of fair value method of accounting for stock options		(129)	(460)
Pro-forma net income	\$ 90,048	\$ 205,700	\$ 276,663
Earnings per share basic and diluted			
As reported	\$ 0.050	\$ 0.104	\$ 0.140
Pro-forma	\$ 0.050	\$ 0.104	\$ 0.140

**Recently adopted accounting pronouncements**

In June 2001, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires the use of the purchase method of accounting for all business combinations initiated after June 30, 2001. SFAS No. 141 requires intangible assets to be recognized if they arise from contractual or legal rights or are separable, i.e., it is feasible that they may be sold, transferred, licensed, rented, exchanged or pledged. As a result, it is likely that more intangible assets will be recognized under SFAS No. 141 than its predecessor, Accounting Principles Board Opinion ( APB Opinion ) No. 16.

Under SFAS No. 142, goodwill is no longer amortized on a straight-line basis over its estimated useful life, but is tested for impairment on an annual basis and whenever indicators of impairment arise. The goodwill impairment test, which is based on fair value, is performed on a reporting unit level. A reporting unit is defined as a SFAS No. 131 operating segment or one level lower. Goodwill is no longer allocated to other long-lived assets for impairment testing under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Additionally, goodwill on equity method investments is no longer amortized; however, it continues to be tested for impairment in accordance with Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. Under SFAS No. 142, intangible assets with indefinite lives are not amortized. Instead they are carried at the lower cost or fair value and tested for impairment at least annually. All other recognized intangible assets are continued to be amortized over their estimated useful lives.

Upon adoption of SFAS No. 142 on January 1, 2002, MTS reclassified the carrying value of goodwill relating to its acquisition of Rosico of \$22 million to licenses. As a result of the useful lives of goodwill and licenses being consistent, the adoption of SFAS No. 142 did not have a significant effect on the Group's results of operations or financial position.

In August 2001, FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale consistent with the fundamental provisions of SFAS No. 121, Accounting for the Impairment of Long-Lived

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Assets and for Long-Lived Assets to be Disposed Of. While it supersedes APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, it retains the presentation of discontinued operations but broadens that presentation to include a component of an entity (rather than a segment of a business). However, discontinued operations are no longer recorded at net realizable value and future operating losses are no longer recognized before they occur. It also establishes a probability weighted cash flow estimation approach to deal with situations in which there is a range of cash flows that may be generated by the asset being tested for impairment. SFAS No. 144 also establishes criteria for determining when an asset should be treated as held for sale. MTS adopted SFAS No. 144 as of January 1, 2002. This change has not had a material effect on the Group's results of operations or financial position.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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Beginning in 2002, MTS adopted the disclosure requirements of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The adoption of SFAS No. 148 did not have a material impact on the results of operations or financial position of the Group.

In November 2002, FASB issued FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires that the guarantor recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing such guarantee. FIN 45 also requires additional disclosures about the guarantor's obligations under certain guarantees that it has issued. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. MTS adopted the disclosure requirements of FIN 45 in 2002. The Group does not expect the adoption of initial recognition and measurement requirements of FIN 45 to have a material impact on its results of operations or financial position.

In January 2003, FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46). FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Under FIN 46, an enterprise is required to consolidate certain entities (so-called variable interest entities), if it is the primary beneficiary of the variable interest entity. The primary beneficiaries of a variable interest entity is the party that absorbs a majority of the entity's expected losses or receives the majority of the entity's residual returns. FIN 46 also requires additional disclosure regarding the use of variable interest entities. MTS adopted the disclosure requirements of FIN 46 effective 2002; consolidation provisions of FIN 46 are effective for interim periods beginning after June 15, 2003. The Group does not believe that the adoption of the consolidation provisions of FIN 46 will have a material effect on its results of operations or financial position.

***New accounting pronouncements***

In June 2001, FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recorded in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the related long-lived asset and depreciated over the asset's useful life. Changes in the liability resulting from the passage of time will be recognized as operating expense.

MTS is required to adopt SFAS No. 143 effective January 1, 2003 and does not anticipate that adoption of this statement will have a material impact on its results of operations or financial position.

In April 2002, FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 4 Reporting Gains and Losses from Extinguishment of Debt, addressed statement of operations classification of gains and losses from extinguishment of debt. SFAS No. 64 amended SFAS No. 4 and is no longer necessary due to the rescission of SFAS No. 4. SFAS No. 145 also amended SFAS No. 13, Accounting for Leases, to require sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback

transactions. Management believes that adoption of SFAS No. 145 will have no impact on the Group's financial statements.

In June 2002, FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which requires the recognition of a liability when incurred for costs associated with an exit or disposal activity. The fundamental conclusion reached by the FASB in this Statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a

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liability. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. MTS will adopt the provisions of SFAS No. 146 for exit or disposal activities that are initiated after December 31, 2002. The Group does not anticipate that adoption of SFAS No. 146 will have a material impact on its results of operations or financial position.

In November 2002, the Emerging Issues Task Force ( EITF ) issued a final consensus on EITF Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on when and how an arrangement involving multiple deliverables should be divided in separate units of accounting. EITF Issue No. 00-21 is effective prospectively for arrangements entered into after June 15, 2003. The Group does not anticipate the adoption of EITF Issue No. 00-21 to have a material impact on its results of operations or financial position.

**4. CHANGE IN ACCOUNTING PRINCIPLE**

Effective January 1, 2001, the Group changed its accounting principle regarding recognition of subscriber acquisition costs. Subscriber acquisition costs represent the direct costs paid for each new subscriber enrolled through MTS independent dealers. Prior to the 2001, these costs were capitalized to the extent of any revenues that had been deferred from the acquisition of a subscriber, such as connection fees charged to a subscriber to initiate call service, and amortized as a component of sales and marketing expense on a straight-line basis over the estimated average subscriber life. MTS now expenses subscriber acquisition costs as incurred. This change of accounting principle was made to facilitate the comparison of MTS results with other telecommunication companies.

As a cumulative effect of this change, the remaining balance of capitalized subscriber acquisition cost as of January 1, 2001 in the amount of \$17,909 (\$0.009 per basic and diluted share), net of \$9,644 in taxes was expensed and included in income during the year ended December 31, 2001.

**5. NEW INVESTMENTS**

In September 2001, MTS won a tender initiated by the Telecommunications Ministry of the Republic of Belarus for a GSM-900/1800 license to operate in Belarus. Under the tender conditions, MTS paid \$10 million, which was written off at December 31, 2001, as the Group believed that there was significant doubt regarding the ability of the Group to commence its operations in Belarus (see also Note 22 Investments In and Advances to Affiliates). During 2002, MTS received all permissions necessary to launch commercial services in Belarus and at December 31, 2002, the Group reflected its share of the results of operations and investment in the joint venture in Belarus in the accompanying consolidated financial statements.

During 2002, MTS and a subsidiary of Sistema established Mobile Positioning Systems ( MTS-P ), a Russian open joint-stock company, to design, develop and operate a positioning system based on the Group's GSM network.

**6. BUSINESSES ACQUIRED**

***Rosico acquisition***

In August 1998, MTS acquired from Sistema 80% of the outstanding common stock of Rosico, a Russian closed joint-stock company, in exchange for 408,631,860 shares of newly issued common stock of MTS representing 25% of then issued and outstanding shares of MTS. Prior to the acquisition, Sistema held a 90%

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interest in Rosico. Rosico holds GSM-1800 licenses covering the Moscow area, 18 regions of Central Russia and 11 regions in the Northern, the Urals and Western Siberia Regions of Russia.

During 2000, MTS acquired the remaining 20% of common stock of Rosico in a number of other acquisitions, for a total of \$16.1 million in cash. As of December 31, 2001 and 2002, MTS owned 100% interest of Rosico.

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***Telecom XXI acquisition***

In May 2001, MTS acquired 100% of the outstanding common stock of Telecom XXI, a Russian closed joint-stock company, for cash consideration of \$49,742. Telecom XXI has GSM-900 and GSM-1800 licenses, covering northwest of Russia, including St. Petersburg and Leningrad region as well as Kaliningrad. Telecom XXI did not have any subscribers at the date of the acquisition. The Telecom XXI acquisition was accounted for using the purchase method of accounting. The purchase price was allocated as follows:

Current assets	\$ 849
Non-current asset	1,322
License costs	74,639
Current liabilities	(944)
Deferred taxes	(26,124)
	<hr/>
Purchase price	<b>\$ 49,742</b>
	<hr/>

License costs are amortized over the remaining term of the license of approximately 7 years at the date of the acquisition.

***Telecom-900 acquisition***

In August 2001, MTS acquired 81% of the outstanding common stock of Telecom-900, a Russian closed joint-stock company, for a cash consideration of \$26,812 from Sistema. Telecom-900 is the holding company for three regional mobile phone operators, Siberia Cellular System 900 CJSC ( SCS-900 ), Uraltel CJSC ( Uraltel ), and Far East Cellular Systems 900 CJSC ( FECS-900 ). At the date of acquisition these companies had approximately 96,000 subscribers. Telecom-900 acquisition was accounted for using the purchase method of accounting. The purchase price was allocated as follows:

Current assets	\$ 12,136
Non-current assets	29,297
License costs	31,542
Current liabilities	(21,883)
Non-current liabilities	(10,626)
Deferred taxes	(7,754)
Minority interest	(5,900)
	<hr/>
Purchase price	<b>\$ 26,812</b>
	<hr/>

In November 2002, MTS acquired the remaining 19% of Telecom-900 from Invest-Svyaz-Holding, a shareholder of the Group, for a cash consideration of \$6,900. The acquisition was accounted for using the purchase method of accounting. The allocation of the purchase price increased recorded license costs by \$2,695.



License costs are amortized over the remaining contractual terms of the respective license, ranging from six to ten years at the date of the first acquisition.

***Kuban-GSM acquisition***

In March 2002, MTS acquired 51% of Kuban-GSM, a Russian closed joint-stock company, for \$71,400 in cash. At the date of acquisition, Kuban-GSM had approximately 500,000 subscribers and it operates in thirteen major cities throughout the south of the European part of the Russian Federation, including Sochi,

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Krasnodar and Novorossiisk. The Kuban-GSM acquisition was accounted for using the purchase method of accounting. The purchase price was allocated as follows:

Current assets	\$ 11,751
Non-current assets	84,409
License costs	62,549
Current liabilities	(31,289)
Non-current liabilities	(19,827)
Deferred taxes	(15,866)
Minority interest	(20,327)
	<hr/>
Purchase price	<b>\$ 71,400</b>
	<hr/>

The remaining interest in Kuban-GSM is owned by KubTelecom, a Russian limited liability company. MTS has the right to buy and KubTelecom has the right to sell all remaining shares of Kuban-GSM held by KubTelecom at fair value anytime until February 15, 2006.

In October 2002, MTS exercised its option to buy an additional 353 shares for \$5,000 payable in cash, increasing its ownership to 52.7%. The acquisition of the additional interest was accounted for using the purchase method of accounting. The allocation of the purchase price increased recorded license costs by \$4,370.

License costs are amortized over the remaining contractual term of the license of approximately 5 years at the date of the acquisition.

***BM Telecom acquisition***

In May 2002, MTS completed its acquisition of 100% of the outstanding common stock of Ufa-based BM Telecom, a closed joint-stock company, for \$41,000 in cash. At the date of acquisition BM Telecom had approximately 100,000 subscribers and it holds a GSM-900/1800 license to operate in Bashkortostan Republic of Russia. This acquisition was accounted for by the purchase method. The purchase price was allocated as follows:

Current assets	\$ 3,312
Non-current assets	14,736
License costs	48,932
Current liabilities	(3,603)
Non-current liabilities	(10,227)
Deferred taxes	(12,150)
	<hr/>
Purchase price	<b>\$ 41,000</b>
	<hr/>

License costs associated with the acquisition of BM Telecom are amortized over the remaining term of the license of approximately 5 years.

*Dontelecom acquisition*

On September 26, 2002, MTS completed its acquisition of 66.66% of the outstanding common stock of Dontelecom for cash consideration of \$15,000 (including 33.33% acquired from Sistema for \$7,500). At the date of acquisition Dontelecom had approximately 39,000 subscribers. Dontelecom holds a GSM-900/1800 license to operate in the Rostov region. This acquisition was accounted for by the purchase method. The purchase price was allocated as follows:

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

Current assets	\$ 3,422
No-current assets	8,401
License costs	14,739
Current liabilities	(5,849)
Non-current liabilities	(357)
Deferred taxes	(3,675)
Minority interest	(1,681)
	<hr/>
Purchase price	<b>\$ 15,000</b>
	<hr/>

In October 2002, the Group completed the acquisition of the remaining 33.33% of the outstanding common stock of Dontelecom for \$7,500. The acquisition was accounted for using the purchase method of accounting. The purchase increased the recorded license costs by \$7,328.

License costs are amortized over the remaining contractual term of the license of approximately 3 years at the date of the acquisition.

***Pro forma results of operations (unaudited)***

The following unaudited pro forma financial data for the years ended December 31, 2001 and 2002, give effect to the acquisitions of Kuban-GSM, BM Telecom and Dontelecom as if they had occurred at the beginning of the respective years.

	December 31	
	2001	2002
	<hr/>	<hr/>
Pro forma:		
Net revenues	\$971,562	\$ 1,394,148
Net operating income	363,856	476,314
Net income	234,556	284,347
Earnings per share, basic	0.118	0.143
Earnings per share, diluted	\$ 0.118	\$ 0.143

**7. Cash and Cash Equivalents**

Cash and cash equivalents as of December 31, 2001 and 2002 comprised of the following:

	December 31	
	2001	2002
	<hr/>	<hr/>
Rubles	\$ 15,282	\$ 19,860
U.S. dollar time deposits	195,000	7,999
U.S. dollars current accounts	7,578	6,404
Other	1,769	398

Total cash and cash equivalents	<u>\$219,629</u>	<u>\$34,661</u>
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**8. Short-Term Investments**

Short-term investments, denominated in U.S. dollars, as of December 31, 2002 comprised of the following:

	<u>Annual interest rate</u>	<u>Maturity date</u>	<u>December 31 2002</u>
OJSC Moscow Bank of Reconstruction and Development	9.0%	October 22, 2003	\$ 19,100
OJSC Moscow Bank of Reconstruction and Development	9.0%	November 21, 2003	5,000
OJSC Moscow Bank of Reconstruction and Development	9.0%	December 5, 2003	5,900
Total short-term investments			<u>\$ 30,000</u>

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

Short-term investments, denominated in U.S. dollars, as of December 31, 2001 were comprised of the following:

	Annual interest rate	Maturity date	December 31 2001
OJSC Moscow Bank of Reconstruction and Development	6.1%	September 30, 2002	\$ 30,000
OJSC Moscow Bank of Reconstruction and Development	6.1%	September 30, 2002	25,000
Sberbank	8.3%	June 28, 2002	10,000
Sberbank	8.3%	June 28, 2002	10,000
Sberbank	8.3%	June 28, 2002	10,000
Other			304
<b>Total short-term investments</b>			<b>\$85,304</b>

Interest income for the years ended December 31, 2000, 2001 and 2002 amounted to \$7,626, \$11,829 and \$8,289, respectively.

**9. Trade Receivables**

Trade receivables as of December 31, 2001 and 2002 were as follows:

	December 31	
	2001	2002
Accounts receivable, subscribers	\$ 19,091	\$ 29,505
Accounts receivable, roaming	10,345	17,266
Allowance for doubtful accounts	(5,178)	(6,270)
<b>Trade receivables, net</b>	<b>\$ 24,258</b>	<b>\$ 40,501</b>

The following table summarizes the changes in the allowance for doubtful accounts for the years ended December 31, 2000, 2001 and 2002:

	December 31		
	2000	2001	2002
Balance, beginning of year	\$ 5,395	\$ 1,819	\$ 5,178
Balance of business acquired		140	34

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Provision for doubtful accounts	2,403	3,219	7,047
Accounts receivable written off	(5,979)		(5,989)
	<u>          </u>	<u>          </u>	<u>          </u>
Balance, end of year	<b>\$ 1,819</b>	<b>\$ 5,178</b>	<b>\$ 6,270</b>
	<u>          </u>	<u>          </u>	<u>          </u>

**10. Inventory**

Inventory as of December 31, 2001 and 2002 comprised of the following:

	<b>December 31</b>	
	<b>2001</b>	<b>2002</b>
	<u>          </u>	<u>          </u>
Spare parts for base stations	\$ 10,795	\$ 15,519
Handsets and accessories	6,232	18,056
Other inventory	9,157	7,811
	<u>          </u>	<u>          </u>
Inventory	<b>\$ 26,184</b>	<b>\$ 41,386</b>
	<u>          </u>	<u>          </u>

Obsolescence expense during the year ended December 31, 2000, 2001 and 2002 amounted to \$2,114, \$2,543 and \$5,614, respectively, and was included in operating expenses in the accompanying consolidated statements of operations.

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**11. Property, Plant and Equipment**

The net book value of property, plant and equipment as of December 31, 2001 and 2002 was as follows:

	December 31	
	2001	2002
Network and base station equipment (including leased network and base station equipment of \$32,248 and \$49,711, respectively)	\$ 616,699	\$ 959,465
Leasehold improvements	7,233	4,299
Office equipment, computers and software (including leased office equipment, computers and software of \$1,824 and \$1,739, respectively)	42,340	68,271
Buildings	37,412	96,420
Vehicles	4,931	7,607
	<u>708,615</u>	<u>1,136,062</u>
Property, plant and equipment, at cost	708,615	1,136,062
	<u>(168,989)</u>	<u>(299,216)</u>
Accumulated depreciation (including accumulated depreciation on leased equipment of \$9,995 and \$13,420, respectively)	(168,989)	(299,216)
Equipment for installation	263,483	313,222
Construction in-progress	52,947	194,565
	<u>263,483</u>	<u>313,222</u>
	<u>52,947</u>	<u>194,565</u>
Property, plant and equipment, net	<b><u>\$ 856,056</u></b>	<b><u>\$ 1,344,633</u></b>

Depreciation expenses during the years ended December 31, 2000, 2001 and 2002 amounted to \$39.9 million, \$73.7 million and \$116.0 million, respectively, including depreciation expenses for leased property, plant and equipment in the amount of \$nil, \$1,589 and \$3,425 respectively.

**12. Other Intangible Assets**

Intangible assets at December 31, 2001 and 2002 comprised of the following:

	December 31	
	2001	2002
Numbering capacity	\$ 66,203	\$ 70,885
Rights to use premises	24,380	25,420
Software and other	47,148	120,674
	<u>47,148</u>	<u>120,674</u>



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	<u>137,731</u>	<u>216,979</u>
Accumulated amortization	(52,953)	(78,889)
Intangible assets, net	<b><u>\$ 84,778</u></b>	<b><u>\$ 138,090</u></b>

As a result of limited availability of local telephone numbering capacity in Moscow and the Moscow region, MTS has been required to enter into agreements for the use of telephone numbering capacity with several telecommunications operators in Moscow. Costs of acquiring numbering capacity are amortized over period of five to ten years in accordance with the terms of the contract entered into to acquire such capacity.

The principal component of MTS' right to use premises was obtained in the form of contributions to its charter capital in 1993. These premises included MTS' administrative offices and facilities utilized for mobile switching centers.

Amortization expense during the years ended December 31, 2000, 2001 and 2002 amounted to \$12.9 million, \$17.5 million and \$30.0 million, respectively.

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**13. Deferred Connection Fees**

Deferred connection fees for the years ended December 31, 2001 and 2002 were as follows:

	December 31	
	2001	2002
Balance at beginning of year	\$ 31,553	\$ 47,412
Payments received and deferred during the year	35,886	19,346
Amounts amortized and recognized as revenue during the year	(20,027)	(24,854)
Balance at end of year	47,412	41,904
Less current portion	21,419	22,210
Non-current portion	<b>\$ 25,993</b>	<b>\$ 19,694</b>

MTS defers initial connection fees from the moment of initial signing of the contract with subscribers and the estimated average subscriber life (see Note 3 Summary of Significant Accounting Policies).

**14. DEBT*****The Notes (see also Note 26 Subsequent Events)***

On December 21, 2001, MTS Finance, a 100% beneficially owned subsidiary of MTS registered under the laws of Luxembourg, issued \$250 million 10.95% notes at the price of 99.254%. Proceeds received from the notes, net of underwriting discount, were \$248 million. Related debt issuance costs in the amount of \$3,856 were capitalized. On March 20, 2002, MTS Finance issued additional \$50 million 10.95% notes at a price of 101.616%. Proceeds received from these notes, including the offering premium, were \$50.8 million. Related debt issuance costs in the amount of \$649 were capitalized. All the notes are guaranteed by MTS OJSC and mature on December 21, 2004. MTS Finance makes interest payments on the notes semi-annually in arrears on June 21 and December 21 of each year, commencing on June 21, 2002. The notes are listed on the Luxembourg Stock Exchange. In May 2002 these notes were registered with the SEC under the Securities Act of 1933.

These notes are subject to certain restrictive covenants including, but not limited to, limitations on the incurrence of additional indebtedness, limitations on the Group's ability to enter into sales leaseback transactions, restriction on any merger, consolidation or disposition of assets, restrictions on the sales of any licenses. In addition, these notes provide the holders a right to require MTS Finance to redeem all of the notes outstanding at 101% of the principal amount of the notes plus accrued interest upon any change in control, as defined.

***Ericsson debt restructuring***

In December 1996, Rosico entered into a credit agreement with Ericsson Project Finance AB ( Ericsson ) that provided for a credit facility with an aggregate principal amount of \$60,000 and had a maximum term of five

years (the Ericsson Loan ). The loan was repayable in ten equal consecutive quarterly payments of \$6,000 commencing in 1999. On July 24, 2001 MTS, Rosico and Ericsson signed an amendment to the credit agreement rescheduling Rosico principal payments in nineteen consecutive quarterly installments. The amounts advanced under the agreement bear interest of LIBOR plus 4% (5.4% at December 31, 2002). If Rosico fails to pay any amount under this facility, the overdue interest would bear interest at a rate of additional 6% per annum. The credit agreement contains covenants restricting Rosico's ability to encumber its present and future assets and revenues without lender's express consent.

Concurrent with the Group's acquisition of Rosico, Sistema agreed to fund the full and timely repayment of the Ericsson Loan and to indemnify Rosico and MTS for any costs incurred by either of Rosico or MTS in connection with the repayment of the Ericsson Loan. During 2000, Sistema and MTS agreed on a method that would allow Sistema to fund its obligation in a manner that minimizes the total costs of meeting this obligation (including related tax costs). Under this method, MTS entered into a long-term, ruble-denominated promissory notes with 0% interest and maturities from 2049 to 2052 to repay a portion of the funding from

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Sistema. The carrying value of these notes is insignificant at December 31, 2001 and 2002. The Group records interest expense on these notes over the term such that the full amount of the obligation will be reflected as a liability at the date of repayment. Through December 31, 2002, Sistema has made payments under this obligation in the amount of \$48,024, \$28,897 of which are repayable in the form of long-term, ruble denominated promissory notes with 0% interest. Amounts receivable from Sistema under this indemnification are recorded as shareholder receivable in the accompanying consolidated balance sheets.

At December 31, 2001 and 2002, \$35 million and \$30 million were outstanding, respectively, under the Ericsson Loan.

***Dresdner bank credit facilities***

In November 2001, Telecom XXI entered into a credit facility with Dresdner Bank CJSC ( Dresdner Bank ) to borrow up to \$20 million. Amounts borrowed by Telecom XXI under this credit facility are repayable within one to six months from the disbursement date and the credit facility has a final repayment date of November 2003. The borrowings bear interest of LIBOR plus 3.2% (4.6% at December 31, 2002) per annum. Default interest is 12% per annum. At December 31, 2001 and 2002 \$3 million and \$20 million were outstanding, respectively, under this agreement and are included in the current portion of long-term debt in the accompanying consolidated balance sheets.

In December 2001 and April 2002, UDN-900 entered into credit agreements with Dresdner Bank, expiring on April 2004. As of December 31, 2001 and 2002, the amounts of borrowings under these agreements were \$ nil and \$4.3 million, respectively. Amounts outstanding under these agreements bear interest of LIBOR plus 3.2% (4.6% December 31, 2002) per annum.

In July 2002, MTS OJSC entered into a credit facility with Dresdner Bank. The credit facility allows borrowings up to \$12 million with the final repayment date no later than June 1, 2004. The amount advanced under the facility bears interest of LIBOR plus 1.95% (3.35% at December 31, 2002) per annum. Default interest is 12% per annum. As of December 31, 2002, \$5 million was outstanding under this credit facility.

***International Moscow bank credit facility***

In November 2001, Telecom XXI entered into a credit facility with the International Moscow Bank to borrow up to \$15 million. Amounts borrowed under the credit facility must be repaid within two months of the first disbursement under the credit facility and bear interest of LIBOR plus 3.1% (4.5% at December 31, 2002) per annum. Default interest is 7.9% per annum. At December 31, 2001 and 2002, \$10 million and \$ nil, respectively, was outstanding under this agreement and is included in the current portion of long-term debt. Amounts outstanding on the facility are guaranteed by MTS OJSC.

***Citibank credit facility***

In November 2002, Telecom XXI entered into a credit facility with Citibank. Amounts borrowed under the credit facility must be repaid in June 2003 and bear interest of LIBOR plus 3.5% (4.9% at December 31, 2002) per annum. Overdue amounts bear an additional 3% per annum. At December 31, 2002, \$9 million outstanding under this facility is included in the current portion of long-term debt. The amounts outstanding on the facility are guaranteed by MTS OJSC.

***Inkombank credit facility to MSS***

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In August 1997, MSS entered into a \$12 million credit facility with OJSC AB Inkombank ( Inkombank ) for the purposes of financing GSM-900 network development. The facility had a final repayment date of March 31, 2002. The amount advanced under the agreement bore interest of 16% per annum. In December 2001, MTS negotiated with Inkombank to pay \$4,169 immediately to extinguish the outstanding obligation of \$6,949. This resulted in an extraordinary gain of \$2,113 (\$0.001 per basic and diluted share), net of taxes of \$667, upon the extinguishment.

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***Sberbank credit facilities***

Kuban-GSM has a number of ruble-denominated credit facility agreements with Sberbank of Russian Federation ( Sberbank ). The amounts borrowed under these credit facilities bear interest at rates varying from 17% to 23% and are to be repaid in regular installments on various dates ending June 2005.

Borrowings under these facilities are secured by a pledge of equipment with carrying value of \$34.5 million at December 31, 2002.

At December 31, 2002, the total amount payable under these facilities, including accrued interest was \$21 million.

***Yugbank loans***

Kuban-GSM has a number of credit facility agreements with Yugbank denominated in rubles. The amounts borrowed under these credit facilities bear interest at rates varying from 19% to 21% and are to be repaid between October 2003 and September 2004. Borrowing under these facilities are secured by a pledge of equipment with a carrying value of \$7 million at December 31, 2002. As of December 31, 2002, the total amount payable under these facilities, including accrued interest was \$3 million.

***Rosbank loan***

In December 2002, Kuban-GSM entered into a ruble-denominated credit agreement with Rosbank, maturing in December 2003. As of December 31, 2002, the amount of borrowings under this agreement was \$3 million. Amounts outstanding under this agreement bears interest at 19% per annum. Borrowings under this facility are secured by a pledge of equipment with a carrying value of \$13 million at December 31, 2002.

***WestLB International loan***

In July 2002, MTS-P entered into a credit facility agreement with WestLB International S.A. As of December 31, 2002, the amount of borrowings under this agreement was \$4 million. Amounts outstanding under this agreement bear interest of EURIBOR plus 2% (4.9% at December 31, 2002) per annum for the first two years for each advance and 4% per annum for the remaining interest periods for each advance until maturity. Final maturity of this agreement is December 28, 2006. The loan is guaranteed by MTS OJSC.

***RTDC loan***

Dontelecom has a loan agreement with Russian Telecommunications Development Corporation ( RTDC ). The principal outstanding amounted to \$1.4 million as of December 31, 2002. The interest rate is fixed at 9.5% per annum on outstanding principal balance. The final maturity of this agreement is December 31, 2003.

***Motorola loan***

Dontelecom has a loan agreement with Motorola for GSM cellular equipment, principal and interest which are payable semiannually; the amounts outstanding bear interest of at 8.23% per annum. The principal amounted to \$1.6 million as of December 31, 2002. Final maturity of this agreement is January 2003.

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The following table presents aggregate scheduled maturities of long-term debt principal as of December 31, 2002:

Payments due in the year ended December 31,	
2003	\$ 67,098
2004	333,133
2005	17,992
2006	7,151
	<u>          </u>
	<b>\$425,374</b>
	<u>          </u>

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

**15. CAPITAL LEASE OBLIGATIONS**

The following table presents future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 2002:

Payments due in the year ended December 31,	
2003	\$ 25,871
2004	7,697
2005	1,549
2006	16
2007	14
Thereafter	32
Total minimum lease payments (undiscounted)	35,179
Less Amount representing interest	(6,706)
Present value of net minimum lease payments	28,473
Less current portion of lease payable	(21,232)
Non-current portion of lease payable	<b>\$ 7,241</b>

For a schedule by years of future minimum lease payments under capital leases to Invest-Svyaz-Holding, a related party, together with the present value of the net minimum lease payments as of December 31, 2002, see Note 20 Related Parties.

**16. ACCRUED LIABILITIES**

Accrued liabilities at December 31, 2001 and 2002 were comprised of the following:

	December 31	
	2001	2002
VAT	\$ 31,213	\$ 29,393
Taxes other than income	13,781	31,810
Interest payable	1,636	1,500
Other accruals	4,996	11,216
Total accrued liabilities	<b>\$ 51,626</b>	<b>\$ 73,919</b>

**17. INCOME TAX**

MTS provision for income taxes is as follows for the respective periods ended:



	December 31		
	2000	2001	2002
Current provision for income taxes	\$ 52,086	\$ 138,092	\$ 129,406
Deferred income tax benefit	(932)	(40,631)	(18,989)
	<u>          </u>	<u>          </u>	<u>          </u>
Total provision for income taxes	<b>\$ 51,154</b>	<b>\$ 97,461</b>	<b>\$ 110,417</b>
	<b>_____</b>	<b>_____</b>	<b>_____</b>

MTS statutory income tax rate in 2000 was 30%. From January 1, 2001, MTS statutory income tax rate was 35% as a result of changes in Russian legislation. The increase in tax rate to 35% resulted in recognition of a deferred tax liability of approximately \$10 million in 2000. In August 2001, a new law regarding taxation of income became effective. Under that law, effective from January 1, 2002, the statutory income tax rate was reduced to 24%. This reduction in the statutory income tax rate resulted in the

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

recognition of a net deferred tax benefit of approximately \$22 million in 2001. The statutory income tax rate reconciled to MTS effective income tax rate is as follows for the respective periods ended:

	December 31		
	2000	2001	2002
Statutory income tax rate for year	30%	35%	24%
Adjustments:			
Expenses not deductible for tax purposes	17.4	13.6	2.1
Tax allowance generated from investment in infrastructure	(18.2)	(8.3)	
Effects of increase in income tax rate	7.0		
Effects of decrease in income tax rate		(6.6)	
Other	1.8	(3.9)	(0.3)
Effective income tax rate	<b>38.0%</b>	<b>29.8%</b>	<b>25.8%</b>

Temporary differences between the tax and accounting bases of assets and liabilities give rise to the following deferred tax assets and liabilities at December 31, 2001 and 2002:

	December 31	
	2001	2002
Assets/(liabilities) arising from tax effect of:		
<b>Deferred tax assets</b>		
Depreciation of property, plant and equipment	\$ 10,050	\$ 13,606
Deferred connection fees	10,910	10,057
Loss carryforward (Rosico and MSS)	14,709	10,033
Other	2,263	9,555
	37,932	43,251
Valuation allowance	(25,892)	(12,695)
Deferred tax assets	12,040	30,556
Less: current portion	5,802	12,223
Non-current portion	<b>\$ 6,238</b>	<b>\$ 18,333</b>
<b>Deferred tax liabilities</b>		
Licenses acquired	\$(66,745)	\$(91,606)
Other	(760)	(14,212)
Total deferred tax liabilities	(67,505)	(105,818)

Net deferred tax liability	<u>\$(55,465)</u>	<u>\$ (75,262)</u>
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As of December 31, 2001 and 2002, Rosico and MSS were entitled to loss carryforwards in the amounts of \$61,286 and \$41,803, respectively. These loss carryforwards resulted in deferred tax assets at December 31, 2001 and 2002 in the amounts of \$14,709 and \$10,033, respectively. As Russian companies are required to file tax declarations on a standalone basis, MTS is not able to utilize these losses to offset its taxable income. The Group has recorded a valuation allowance for the entire tax loss carryforward related to Rosico and MSS since it is more likely than not that the tax asset will not be realized.

#### **18. SHAREHOLDERS EQUITY**

In accordance with Russian laws, earnings available for dividends are limited to profits determined in accordance with Russian statutory accounting regulations, denominated in rubles, after certain deductions. Net income of MTS OJSC for the year ended December 31, 2001 and 2002 which is distributable under Russian legislation totaled 8,587 million rubles (\$294,381) and 10,759 million rubles (\$343,278), respectively.

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

## 19. STOCK BONUS AND STOCK OPTION PLANS

On April 27, 2000, contingent on the closing of MTS initial public offering (see Note 1 General), MTS established a stock bonus plan and stock option plan for selected officers, key employees and key advisors. Under these plans, directors, key employees and key advisors received 3,587,987 of MTS common shares as well as the right to participate in a stock option plan under which they may receive options to purchase up to an additional 9,966,631 of MTS common shares. At the time of the initial public offering, MTS OJSC issued 13,554,618 shares of common stock to its subsidiary Rosico pursuant to these plans at a price of \$1.024 per share for the total amount of \$13.9 million. These shares have been classified as treasury stock in the accompanying consolidated balance sheets.

Under the stock bonus plan, during September 2000, 3,587,987 common shares were purchased from Rosico at nominal price of 0.1 rubles per share as follows:

	Number of shares purchased	Percentage of total shares outstanding
Employees and Directors	3,049,786	0.153
Key Advisors	538,201	0.027
<b>Total</b>	<b>3,587,987</b>	<b>0.180</b>

All those listed above were restricted from selling these shares for 180 days from the date of purchase. On the date the shares were granted, MTS recognized aggregate expenses under this plan as compensation and consulting expenses amounting to \$4,500 and \$797, respectively, based on the fair value of the shares (see also Note 20 Related Parties).

Options under the stock option plan are generally granted at an exercise price equal to the average sale price of MTS stock on New York Stock Exchange over a 100-day period preceding the grant date and vest over the period not exceeding two years, contingent on continued employment or board membership of participants.

During 2001 and 2002, MTS made several grants pursuant to its stock option plan to employees and directors of the Group. A summary of the status of the Group's stock option plan as of December 31, 2001 and 2002, is presented below:

	Shares	Weighted average exercise price
Outstanding at January 1, 2001		
Granted during 2001	1,829,221	\$ 1.31
Outstanding at December 31, 2001	1,829,221	1.31
Granted	2,846,681	1.49
Forfeited	27,481	1.31

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Outstanding December 31, 2002	<b>4,648,421</b>	<b>\$ 1.42</b>
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None of the options outstanding at December 31, 2001 and 2002, were exercisable. Options outstanding at December 31, 2002, have exercise price ranging from \$1.31-\$1.49 per share and a their weighted average remaining contractual life was approximately 2 years at December 31, 2002.

Fair values of options granted in 2001 and 2002 were \$0.36 and \$0.50 per share, respectively, and were estimated using the Black-Scholes option pricing model. The risk free rates applied for 2001 and 2002 were 15.5% and 6.1%, respectively. The following assumptions were applied to options granted in 2001 and 2002, respectively: (i) expected dividend yields of nil% and nil%; (ii) expected volatility rates of 45% and 50% and (iii) expected lives of 2 years for 2001 and 2002.

In accordance with the Russian legislation, MTS Board members and key employees may be considered insiders with respect to the Group and thus may be restricted from selling their shares.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

## 20. RELATED PARTIES

Related party balances as of December 31, 2001 and 2002 comprised of the following:

	December 31	
	2001	2002
Accounts receivable:		
T-Mobile receivable for roaming	\$ 677	\$ 1,374
Receivables from investee companies	1,700	2,195
	<u>          </u>	<u>          </u>
Total accounts receivable, related parties	<b>\$ 2,377</b>	<b>\$ 3,569</b>
	<u>          </u>	<u>          </u>
Accounts payable:		
T-Mobile payable for consulting services	\$ 1,970	\$
T-Mobile other payables	1,266	
Telmos for interconnection	207	184
MTU-Inform for interconnection	2,593	4,154
MGTS for interconnection	106	630
	<u>          </u>	<u>          </u>
Total accounts payable, related parties	<b>\$ 6,142</b>	<b>\$ 4,968</b>
	<u>          </u>	<u>          </u>

*Moscow Bank of Reconstruction and Development (MBRD)*

Starting August 2000, MTS has been keeping certain bank and deposit accounts with MBRD, whose major shareholder is Sistema. As of December 31, 2001, MTS cash position at MBRD amounted to \$112.4 million including \$105 million in time deposits and \$7.4 million in current accounts. As of December 31, 2002, MTS cash position at MBRD amounted to \$38.7 million including \$34.0 million in time deposits and \$4.7 million in current accounts. The related interest accrued and collected on the deposits for the years ended December 31, 2001 and 2002 amounted to \$3.0 million and \$5.1 million, respectively, and was included as a component of interest income in the accompanying consolidated statements of operations.

*Rosno OJSC*

MTS arranged medical insurance for its employees and insured its property at the amounts of approximately \$274 million, \$612 million and \$781 million in 2000, 2001 and 2002, respectively, with Rosno OJSC, whose significant shareholder is Sistema. Insurance premiums paid to Rosno OJSC for the years ended December 31, 2000, 2001 and 2002, amounted to \$6.5 million, \$8.0 million and \$4.9 million, respectively, including premiums paid for medical insurance amounting to \$1.6 million, \$2.5 million and \$3.6 million, respectively. Management believes that all of the insurance contracts with Rosno OJSC have been entered at market terms.

*Maxima Advertising Agency (Maxima)*

In 2000, 2001 and 2002, MTS had agreements for advertising services with Maxima. Advertising fees paid to Maxima for the years ended December 31, 2000, 2001 and 2002, were \$6.4 million, \$8.7 million and \$13.1 million, respectively. Maxima is related to MTS through MTS directors who are also members of

Maxima's board of directors.

*Telmos*

In 2000, 2001 and 2002, MTS had interconnection arrangements with, and received domestic and international long-distance services from, Telmos, a subsidiary of Sistema. Interconnection and line rental fees paid to Telmos for the years ended December 31, 2000, 2001 and 2002, were approximately \$4.3 million, \$4.0 million and \$1.3 million, respectively. Management believes that these arrangements are at market terms.

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**Table of Contents****OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)*****Moscow City Telephone Network (MGTS)***

In 2000, 2001 and 2002, MTS had line rental agreements with MGTS and rented cable plant from MGTS for installation of optic-fiber cable. MTS also rented buildings for administrative office, sales and marketing offices as well as premises for switching and base station equipment. Amounts paid under these agreements for the years ended December 31, 2000, 2001 and 2002, were approximately \$1.0 million, \$1.5 million and \$4.4 million, respectively. In 2000, 2001 and 2002, MTS also purchased buildings from MGTS and paid \$2.9 million, \$2.6 million and \$2.0 million, respectively. Management believes that all these transactions were made at market terms. Sistema is the majority shareholder of MGTS.

***MTU-Inform***

In 2000, 2001 and 2002, MTS had interconnection and line rental agreements with MTU-Inform, a subsidiary of Sistema. Amounts paid under these agreements for the years ended December 31, 2000, 2001, and 2002, amounted to approximately \$17.4 million, \$29.0 million and \$24.1 million, respectively. In 2000, 2001 and 2002 MTS also purchased telephone numbering capacity from MTU-Inform. Payments under these agreements for the years ended December 31, 2000, 2001 and 2002, amounted to \$11.7 million, \$4.7 million and \$1.6 million, respectively. Management believes that these agreements are at market terms.

***T-Mobile***

In 2000, 2001 and 2002, the Group had roaming agreements with T-Mobile, a shareholder of the Group and its subsidiaries. Payments made by MTS under these roaming agreements were approximately \$0.7 million, \$0.7 million and \$1.0 million for the years ended December 31, 2000, 2001 and 2002, respectively. In addition, during 2000 T-Mobile provided consulting services to the Group for \$2.7 million.

***Invest-Svyaz-Holding***

In 2001 and 2002, subsidiaries of Telecom-900, Uraltel, FECS-900 and SCS-900 entered into agreements with Invest-Svyaz-Holding, a shareholder of MTS, for leasing of network equipment and billing system. These leases were recorded as capital leases based on the requirements of SFAS No. 13, Accounting for Leases. The present value of future lease payments is reflected as a liability in the balance sheet. Amounts due within 1 year are classified as short-term, the remaining balance as long-term liabilities. The interest rate implicit in these leases varies from 15% to 44%, which management believes are market terms.

The following table summarizes the future minimum lease payments under capital leases to Invest-Svyaz-Holding together with the present value of the net minimum lease payments as of December 31, 2002:

Payments due in the year ended December 31	
2003	\$ 6,554
2004	4,621
2005	1,199
	<hr/>
Total minimum lease payments (undiscounted)	12,374
	<hr/>
Less Amount representing interest	(3,331)
	<hr/>



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Present value of net minimum lease payments	9,043
Less current portion of lease payable	(4,879)
	<hr/>
Non-current portion of lease payable	<b>\$ 4,164</b>
	<hr/>

In addition to the above lease transactions, the Group guarantees debt of Invest-Svyaz-Holding in the amount of \$7 million to a third party, which is used by Invest-Svyaz-Holding primarily to finance its leases to the Group. For the year ended leases to the Group amount to approximately 99% of revenues of Invest-Svyaz-Holding.

Principal and interest paid to Invest-Svyaz-Holding for the period from the date of acquisition of Telecom-900 on August 10, 2001 through December 31, 2001, were \$503 and \$139, respectively. For the

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year ended December 31, 2002, principal and interest paid to Invest-Svyaz-Holding were \$2.9 million and \$1.4 million, respectively.

**Other**

In 2000, consultants from MTS two major shareholders advised MTS in connection with MTS's initial public offering. In April 2000, contingent on the closing of this stock offering, MTS established a stock bonus plan (see Note 19 Management Stock Bonus and Stock Option Plans). Under this plan, consultants purchased 538,201 common shares of MTS from Rosico at nominal price 0.1 rubles per share. In 2000, MTS recognized consulting expenses under this plan in the amount of \$797 based on the fair value of the shares on the date of grant.

As discussed in Note 6 Businesses Acquired, during 2001 and 2002 MTS acquired 81% and 19%, respectively, of the outstanding common stock of Telecom-900, for \$26.8 million and \$6.9 million, respectively, in cash from Sistema and Invest-Svyaz-Holding, respectively. Additionally in 2002, MTS acquired 33.33% of the outstanding common stock of Dontelecom from Sistema for \$7.5 million in cash.

**21. OPERATING EXPENSES**

Operating expenses for 2000, 2001 and 2002, consisted of the following:

	<b>December 31</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
Salaries and social contributions	\$ 33,753	\$ 44,425	\$ 84,706
Taxes other than income taxes	26,859	25,312	39,119
General and administrative	20,355	21,569	26,549
Rent	7,241	9,479	15,578
Insurance	4,251	5,258	6,774
Repair and maintenance	3,225	10,578	20,361
Provision for doubtful accounts	2,403	3,219	7,047
Consulting expenses	2,621	2,093	7,692
Billing and data processing	2,285	2,981	9,549
Other operating expenses	7,249	9,684	11,681
	<b>\$ 110,242</b>	<b>\$ 134,598</b>	<b>\$ 229,056</b>

**22. INVESTMENTS IN AND ADVANCES TO AFFILIATES**

At December 31, 2001 and 2002, Group's investments in and advances to affiliates included, respectively, the following:

	<b>December 31</b>	
	<b>2001</b>	<b>2002</b>

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MTS Belarus loans receivable	\$	\$30,089
MTS Belarus equity investment		2,455
Receivables from other investee companies	740	1,490
	—	—
Total investments in and advances to affiliates	<b>\$740</b>	<b>\$34,034</b>

In September 2001, MTS won a tender initiated by the Telecommunications Ministry of the Republic of Belarus to form a joint venture which will have a GSM-900/1800 license to operate in Belarus. In accordance with the tender, in November 2001 the Group made an initial \$10 million payment to the government of Belarus.

From December 2001, soon after the date the Group was awarded the tender, it became increasingly apparent based upon various communications and correspondence that the Group would not be able to commence operations in Belarus as expected. The Company halted additional payments under the original

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agreement and expensed its initial \$10 million investment, as it appeared probable that the investment would not be recoverable. This charge is reflected as an impairment of investment in the accompanying consolidated statements of operations for the year ended December 31, 2001.

As a result of additional negotiations, and a change in the Belarus government's position, effective June 26, 2002, the joint venture received all of the governmental approvals and licenses required to commence operations in Belarus. Subsequently, the Group began investing in MTS Belarus.

For the year ended December 31, 2002, the Group provided MTS Belarus with \$30.1 million in loans bearing interest at 11% with repayment terms of between February and June 2003. Based on projected future cash flows, the Group has concluded that an additional impairment is not required as of December 31, 2002.

**23. OPERATING LICENSES**

In connection with providing telecommunication services, the Group has been issued various operating licenses by the Ministry of Communications. In addition to the licenses received directly from the Ministry of Communications, the Group was granted access to various telecommunication licenses through acquisitions. At December 31, 2002, recorded values of the Group's telecommunication licenses were as follows:

	<b>December 31 2002</b>
Moscow license area (Rosico)	\$ 255,812
North-Western region (Telecom XXI)	74,639
Krasnodar and Adigea regions (Kuban-GSM)	66,919
Bashkortostan Republic (BM Telecom)	48,932
Five regions of Asian Russia (Telecom-900)	34,237
Rostov region (Dontelecom)	22,067
Seven regions of European Russia	19,503
Other	8,212
	<hr/>
Licenses, at cost	530,321
	<hr/>
Accumulated amortization	(143,402)
	<hr/>
Licenses, net	<b>\$ 386,919</b>

The following table summarizes GSM-900/1800 telecommunication licenses held by the Group at December 31, 2002:

License region	GSM-900		GSM-1800	
	Licensee	Expiry date	License	Expiry date
Moscow License Area				

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Moscow	MTS OJSC	December 1, 2004	Rosico	April 28, 2008
Moscow				
Region	MTS OJSC	December 1, 2004	Rosico	April 28, 2008
<b>St. Petersburg License Area</b>				
St. Petersburg	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Leningrad				
Region	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
<b>Regional License Areas</b>				
<b>European Russia</b>				
Adygeya				
Republic	Kuban-GSM	April 28, 2008		
Arkhangelsk	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Bashkortostan				
Republic	BM Telecom	August 22, 2007	BM Telecom	August 22, 2007
Belgorod	ReCom	May 15, 2008	Rosico	April 28, 2008
Bryansk	ReCom	May 15, 2008	Rosico	April 28, 2008
Ivanovo			Rosico	April 28, 2008
Kaliningrad	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008

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(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

License region	GSM-900		GSM-1800	
	Licensee	Expiry date	License	Expiry date
Kalmykia Republic	BIT	January 25, 2011		
Kaluga	MTS OJSC	October 1, 2006	Rosico	April 28, 2008
Karelia	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Kirov	Rosico	April 28, 2008	Rosico	April 28, 2008
Komi Republic	MTS OJSC	August 22, 2007	Rosico	April 28, 2008
Komi-Permyatsk			Rosico	April 28, 2008
Kostroma	MTS OJSC	August 22, 2007	Rosico	April 28, 2008
Krasnodar Region	Kuban-GSM	May 30, 2007	Kuban-GSM	May 30, 2007
Kursk	ReCom	May 15, 2008	Rosico	April 28, 2008
Lipetsk	ReCom	May 15, 2008	Rosico	April 28, 2008
Murmansk	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Nenetsk	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Nizhny Novgorod	Rosico	April 28, 2008	Rosico	April 28, 2008
Novgorod	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Orel	ReCom	May 15, 2008	Rosico	April 28, 2008
Orenburg			Rosico	April 28, 2008
Perm	Rosico	April 28, 2008	Rosico	April 28, 2008
Rostov	Dontelecom	July 1, 2005	Dontelecom	July 1, 2005
Pskov	MTS OJSC	October 1, 2006		
Pskov	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Ryazan	MTS OJSC	October 1, 2006	Rosico	April 28, 2008
Saratov	MTS OJSC	July 11, 2012		
Smolensk	MTS OJSC	October 1, 2006	Rosico	April 28, 2008
Tambov			Rosico	April 28, 2008
Tula	MTS OJSC	October 1, 2006	Rosico	April 28, 2008
Tver	MTS OJSC	April 4, 2007	Rosico	April 28, 2008
Udmurt Republic	UDN-900	February 21, 2007	Rosico	April 28, 2008
Vladimir	MTS OJSC	October 1, 2006	Rosico	April 28, 2008
Vologda	Telecom XXI	April 28, 2008	Telecom XXI	April 28, 2008
Voronezh	ReCom	May 15, 2008	Rosico	April 28, 2008
Yaroslavl			Rosico	April 28, 2008
Samara Region	MTS OJSC	December 30, 2012	MTS OJSC	December 30, 2012
<b>Asian Russian</b>				
Altai Region	Mobicom-Barnaul	September 8, 2010		
Altai Republic	SCS-900	July 19, 2011		
Amursk	ACC	January 10, 2007		
Chelyabinsk	Rosico	April 28, 2008	Rosico	April 28, 2008
Chukotka	BIT	July 19, 2011		
Khabarovsk	FECS-900	January 10, 2007	FECS-900	January 10, 2007
Kurgan			Rosico	April 28, 2008
Khanty Mansiysk			Rosico	April 28, 2008
Novosibirsk	SCS-900	February 21, 2007	SCS-900	February 21, 2007
Omsk	MSS	December 20, 2006		
Sakhalin	BIT	July 19, 2011		
Sverdlovsk Region	Uraltel	March 1, 2006	Uraltel	March 1, 2006
Sverdlovsk Region			Rosico	April 28, 2008

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Tyumen			Rosico	April 28, 2008
Tyva Republic	BIT	July 19, 2011		
Yamalo-Nenetsk			Rosico	April 28, 2008

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)**

Each of the Group's licenses, except the licenses covering the Moscow license area, contains a requirement that service be commenced and that subscriber-number and territorial-coverage targets be achieved by a specified date. The Group has met these targets or received extensions to these dates in those regional license areas in which the Group has not commenced operations. The management believes that the Group is in compliance with all material terms of our licenses.

When MTS commenced its operations in 1994, licenses generally contained certain provisions for unspecified fees to be paid for utilization of the frequency. Most of MTS' current licenses now provide for payments to be made to finance telecommunication infrastructure improvements, which in the aggregate could total approximately \$110,244. However, no decisions regulating the terms and conditions of such payments have been formulated. Accordingly, no payments have been made to date pursuant to any of the current licenses, which could require such payments. Further, management believes that the Group will not be required to make any such payments. If such payments would be required in the future, management believes that it would be limited to purchasing certain equipment for its own use in the related license area.

In relation to these uncertainties, no amounts have been recorded in the accompanying financial statements.

**24. COMMITMENTS AND CONTINGENCIES**

***Commitments***

As of December 31, 2002, MTS committed to further purchase of network property, plant and equipment in the amount of approximately \$306 million.

As of December 31, 2002, MTS guaranteed bank loans of Invest-Svyaz-Holding ( ISH ), a shareholder of the Group, in the amount of \$7 million, which were primarily used to finance Invest-Svyaz-Holding's leases to the Group. Under these guarantees, MTS is liable for all amounts outstanding under certain bank loans of Invest-Svyaz-Holding in case ISH defaults on the payment. The guarantees expire between August 2003 and April 2005. No liability in respect of these guarantees has been recorded in the accompanying consolidated financial statements.

***Negative net equity of Rosico***

In accordance with Russian legislation, joint-stock companies must maintain a level of equity (net assets) that is greater than the charter capital. In the event that a company's equity (net assets), as determined under Russian accounting legislation, falls below certain minimum levels, specifically below zero, such company can be forced to liquidation.

During the past several years Rosico reported significant losses in its financial statements compiled in accordance with Russian accounting legislation. As a result, at December 31, 2001 and 2002, Rosico reported a deficit in equity (negative net equity) in its financial statements compiled in accordance with Russian accounting legislation.

**25. SEGMENT INFORMATION**

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, established standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise engaging in business activities about which separate financial information is available that is evaluated regularly by the chief operating decision maker or group in deciding how to allocate



resources and in assessing performance. The Group's business is organized based on geographical operations. Management of the Group regularly reviews certain operational and statistical information by license area, however currently no discrete financial information is available on this basis, therefore the performance is measured and decisions about resource allocation are made by management based on operating income by legal entities as an aggregate of the license area information.

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## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)

At December 31, 2002, the Group had several operating segments, of which one is a reportable segment MTS OJSC and Rosico, which operates primarily in the Moscow license area and also has license footprint covering several other regions.

	Year ended December 31		
	2000	2001	2002
Revenue:			
MTS OJSC and Rosico.	\$ 534,433	\$ 831,857	\$ 1,044,877
Other	1,279	64,780	370,309
Intercompany eliminations		(3,390)	(53,430)
<b>Total revenue</b>	<b>\$ 535,712</b>	<b>\$ 893,247</b>	<b>\$ 1,361,756</b>
Operating income:			
MTS OJSC and Rosico.	\$ 141,147	\$ 316,894	\$ 365,698
Other	(2,100)	8,039	102,862
Intercompany eliminations		(824)	(4,189)
<b>Total operating income</b>	<b>\$ 139,047</b>	<b>\$ 324,109</b>	<b>\$ 464,371</b>
Depreciation and amortization:			
MTS OJSC and Rosico.	\$ 85,796	\$ 114,923	\$ 144,004
Other	1,888	18,395	65,676
<b>Total depreciation and amortization</b>	<b>\$ 87,684</b>	<b>\$ 133,318</b>	<b>\$ 209,680</b>
Additions to long-lived assets:			
MTS OJSC and Rosico.	\$ 243,037	\$ 415,336	\$ 360,598
Other		176,211	344,739
<b>Total additions to long-lived assets</b>	<b>\$ 243,037</b>	<b>\$ 591,547</b>	<b>\$ 705,337</b>

	As of December 31	
	2001	2002
Long-lived assets:		
MTS OJSC and Rosico.	\$ 1,045,034	\$ 1,288,062
Other	195,451	585,769
Intercompany eliminations	(824)	(4,189)

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Total long-lived assets	<b>\$ 1,239,661</b>	<b>\$ 1,869,642</b>
	<hr/>	<hr/>
Total assets:		
MTS OJSC and Rosico.	\$ 1,625,053	\$ 1,923,682
Other	232,846	690,481
Intercompany eliminations	(130,407)	(330,867)
	<hr/>	<hr/>
Total assets	<b>\$ 1,727,492</b>	<b>\$ 2,283,296</b>
	<hr/>	<hr/>

**26. SUBSEQUENT EVENTS**

*Issue of Eurobonds*

On January 30, 2003, MTS Finance issued \$400 million 9.75% notes at par. These notes are guaranteed by MTS OJSC and mature on January 30, 2008. MTS Finance will make interest payments on the notes semi-annually in arrears on January 30 and July 30 of each year, commencing on July 30, 2003. The notes are listed on the Luxembourg Stock Exchange. Proceeds received from the notes were \$400 million and related debt issuance costs of \$3.9 million were capitalized.

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**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)**

***Acquisition of UMC***

On March 4, 2003, MTS acquired 57.7% of the outstanding voting interest of Ukrainian Mobile Communications ( UMC ), a provider of mobile services in Ukraine, for cash consideration of \$194,200, including the acquisition of 16.3% of the outstanding voting interest from Deutsche Telecom, a related party, for \$55,000. In connection with the acquisition, MTS also assumed debt of UMC with face value of approximately \$65 million. At the date of acquisition, UMC had approximately 1.8 million subscribers.

MTS also had an option agreement with Ukrtelecom to purchase its remaining 26% stake in UMC, exercisable from February 5, 2003 to November 5, 2005, with an exercise price of \$87,600. On June 4, 2003 MTS exercised its call option. As a result of the transaction, MTS ownership in UMC has increased from 57.7% to 83.7%.

In addition, MTS entered into a put and call option agreement with TDC International for the purchase of its 16.3% stake in UMC. The exercise period of the call option is from May 5, 2003 to November 5, 2004, and the put option is exercisable from August 5, 2003 to November 5, 2004. The call option price is \$85,000 plus interest accrued from November 5, 2002 to the date of the exercise at 11% per annum; put option price is calculated based on reported earnings of UMC prior to the exercise and is subject to a minimum amount of \$55,000. Purchase price allocation for the acquisition of UMC has not been finalized at the date of these statements.

***Acquisition of TAIF Telcom***

On April 2, 2003, MTS acquired 51% of common shares of TAIF Telcom, a Russian open joint-stock company, for \$51 million and 50% of preferred shares of TAIF Telcom for \$10 million.

In addition, MTS has signed call and put option agreements with the existing shareholders of TAIF Telcom to acquire the remaining 49% common and 50% preferred shares of TAIF Telcom. The exercise period of the call options for common shares is 48 months from the date of acquisition of a 51% stake in TAIF Telcom and the put options for common shares are exercisable for 36 months from the date falling 18 months after the date of acquisition of the first stake in TAIF Telcom by MTS. A minimum price of the call and put options for common shares is \$49 million plus 8% per annum starting from the moment of acquisition of the first stake of TAIF Telcom by MTS. The exercise period of the call options for preferred shares is 48 months from the date falling 24 months after the date of acquisition of a 51% of TAIF Telcom and the put options for preferred shares are exercisable for 24 months from the date falling 24 months after the date of acquisition of the first stake in TAIF Telcom by MTS. A minimum price of the call and the put options for preferred shares is \$10 million plus 8% per annum starting from the moment of acquisition of the first stake of TAIF Telcom by MTS.

If all options are exercised, MTS share in TAIF Telcom will increase to 100%.

TAIF Telcom provides mobile services in the GSM-900/1800 standard in the Republic of Tatarstan and in the Volga region of Russia. At the date of acquisition, TAIF Telcom had approximately 240,000 subscribers. Purchase price allocation for the acquisition of TAIF Telcom has not been finalized at the date of these statements.

***Transactions by major shareholders***

In March 2003, Sistema and T-Mobile (together, the Shareholders ) entered into a call option agreement, pursuant to which T-Mobile granted Sistema the option to acquire from it 199,322,614 shares of MTS,

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representing 10% of MTS. The call option is exercisable to September 30, 2003. In connection with this agreement, the Shareholders entered into an additional agreement relating to the management of MTS (subject to approvals by the Russian Ministry of Antimonopoly Policy and Support of Entrepreneurial Activity, or MAP). The major terms of the agreement are as follows:

T-Mobile is required to vote when necessary to ensure, as much as possible, that Sistema will have the majority of the MTS board of directors;

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**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Amounts in thousands of U.S. dollars, except share and per share amounts or if otherwise stated)**

T-Mobile will be required to approve certain transactions such as significant acquisitions, share issuances that dilute T-Mobile's ownership, etc;

a dividend policy will be approved by the Shareholders, with the expectation that annual distributions on not less than 25% of MTS OJSC net profits, according to Russian accounting standards, will be made as dividends annually, beginning effective 2003.

In April 2003, Sistema issued \$350 million 10.25% notes, due in 2008. These notes are secured by 193,473,900 shares of common stock of MTS.

On April 26, 2003, Sistema exercised its option with T-Mobile to purchase an additional 6% of the outstanding common stock of the Group and purchased T-Mobile's 49% interest in Invest-Svyaz-Holding. Concurrently with this transaction, T-Mobile sold 5% of its holding in the Group on the open market in the form of Global depository receipts, or GDRs listed on the London Stock Exchange.

On May 19, 2003, the Group announced cash dividends of \$1.10 per ADS (\$0.055 per share) for a total of \$110 million to be paid during June 2003.

***Additional debt issuance***

In March 2003, the Board of Directors of MTS OJSC approved the issuance of ruble denominated bonds for up to 5 billion rubles (\$161 million).

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**POLSKA TELEFONIA CYFROWA SP. Z O.O.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE YEARS ENDED  
DECEMBER 31, 2002 (UNAUDITED), DECEMBER 31, 2001  
AND DECEMBER 31, 2000  
TOGETHER WITH REPORT OF  
INDEPENDENT PUBLIC ACCOUNTANTS  
FOR THE CONSECUTIVE YEARS ENDED  
DECEMBER 31, 2001**

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**POLSKA TELEFONIA CYFROWA SP. Z O.O.**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED**

**DECEMBER 31, 2002 (UNAUDITED), 2001 AND 2000**

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**This report is a copy of a previously issued Andersen affiliate report and the Andersen affiliate has not reissued the report.**

**REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS**

**To the Supervisory Board of Polska Telefonia Cyfrowa Sp. z o.o.**

We have audited the accompanying consolidated balance sheets of Polska Telefonia Cyfrowa Sp. z o.o. (a Polish limited liability company) and its subsidiaries as of December 31, 2001, 2000 and 1999, and the related consolidated statements of operations, consolidated statements of changes in equity and consolidated statements of cash flows for each of the consecutive three years ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Polska Telefonia Cyfrowa Sp. z o.o. and its subsidiaries, as at December 31, 2001, 2000 and 1999, and the results of their operations and their cash flows for each of the consecutive three years ended December 31, 2001 in accordance with Statements of International Accounting Standards ( IAS ) issued by the International Accounting Standards Board ( IASB ).

Accounting practices used by the Company in preparing the accompanying consolidated financial statements conform with IAS but do not conform with accounting principles generally accepted in the United States ( US GAAP ). A description of these differences and a reconciliation of net income and shareholders' equity from accounting principles generally accepted under IAS and US GAAP are set forth in Note 32.

As explained in Note 4.1.b to the consolidated financial statements, the Company has given retrospective effect to the change in its revenue recognition policy relating to multiple-element contracts.

Arthur Andersen Sp. z o.o.

Warsaw, Poland

March 1, 2002

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## POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES

## Consolidated Income Statements

for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)

	Notes	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
		(unaudited)		(restated)
Net sales	6	4,929,824	4,344,896	3,684,723
Cost of sales	7	(2,989,193)	(2,727,437)	(2,286,426)
<b>Gross margin</b>		<b>1,940,631</b>	<b>1,617,459</b>	<b>1,398,297</b>
Operating expenses	7	(790,115)	(785,429)	(766,016)
<b>Operating profit</b>		<b>1,150,516</b>	<b>832,030</b>	<b>632,281</b>
<b>Non-operating items</b>				
Interest and other financial income	8	266,454	316,616	227,125
Interest and other financial expenses	9	(848,132)	(694,546)	(716,665)
<b>Profit before taxation</b>		<b>568,838</b>	<b>454,100</b>	<b>142,741</b>
Taxation charge	10	(222,362)	(26,879)	(33,354)
<b>Net profit for the year</b>		<b>346,476</b>	<b>427,221</b>	<b>109,387</b>

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Consolidated Balance Sheets**

**as at December 31, 2002 and December 31, 2001**  
(in thousands of PLN)

	Notes	As at December 31, 2002	As at December 31, 2001
(unaudited)			
<b>Current assets</b>			
Cash and cash equivalents	26	54,412	36,511
Short-term investments and other financial assets	11	12,143	98,278
Debtors and prepayments	12	620,749	538,822
Inventory	13	234,545	167,114
		<u>921,849</u>	<u>840,725</u>
<b>Long-term assets</b>			
Property, plant and equipment	14	3,438,686	3,783,810
Intangible fixed assets	15	2,651,130	2,412,810
Financial assets	16	171,288	105,985
Deferred costs and other long-term assets	17	82,091	74,123
		<u>6,343,195</u>	<u>6,376,728</u>
<b>Total assets</b>		<b><u>7,265,044</u></b>	<b><u>7,217,453</u></b>
<b>Current liabilities</b>			
Accounts payable	18	285,277	286,621
Amounts due to State Treasury	18	57,756	46,184
Interest-bearing liabilities	18	121,122	190,429
Accruals	20	185,569	123,686
Deferred income and other liabilities	18	224,358	224,260
		<u>874,082</u>	<u>871,180</u>
<b>Long-term liabilities</b>			
Interest-bearing liabilities	19	4,583,365	5,083,933
Non-interest-bearing liabilities	19	165,159	193,822
Deferred tax liability	10	268,171	52,121
Provisions for liabilities and charges	20	21,740	20,652
		<u>5,038,435</u>	<u>5,350,528</u>
<b>Total liabilities</b>		<b><u>5,912,517</u></b>	<b><u>6,221,708</u></b>
<b>Capital and reserves</b>			
Share capital	21	471,000	471,000
Additional paid-in capital		409,754	409,754
Hedge reserve		(86,649)	(96,955)
Accumulated profit		558,422	211,946
		<u>1,352,527</u>	<u>995,745</u>
<b>Total equity and liabilities</b>		<b><u>7,265,044</u></b>	<b><u>7,217,453</u></b>



The accompanying notes are an integral part of these consolidated financial statements.

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Table of Contents**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
<b>Net profit before taxation</b>	<b>568,838</b>	<b>454,100</b>	<b>142,741</b>
<b>Adjustments for:</b>			
Depreciation and amortization	909,983	850,572	519,705
Charge to provision and write-offs of doubtful debtors	29,224	67,626	146,624
Charge to provision for inventory	7,333	11,151	7,082
Other provisions long-term	1,089	7,744	9,144
Foreign exchange (gains)/losses, net and changes in financial instruments fair value	145,394	(91,609)	(92,207)
(Gain)/loss on disposal of tangibles and intangibles	10,804	(1,582)	8,664
Interest expense, net	436,283	469,539	501,580
<b>Operating cash flows before working capital changes</b>	<b>2,108,948</b>	<b>1,767,541</b>	<b>1,243,333</b>
(Increase)/decrease in inventory	(74,764)	31,025	(32,392)
Increase in debtors, prepayments and deferred cost	(101,165)	(129,383)	(104,527)
Increase/(decrease) in trade payables and accruals	90,529	24,560	20,142
<b>Cash from operations</b>	<b>2,023,548</b>	<b>1,693,743</b>	<b>1,126,556</b>
Interest paid	(482,978)	(450,820)	(453,183)
Interest received	17,182	15,213	38,005
Income taxes paid	(1,618)	(1,325)	(4,451)
Realization of financial instruments	(32,973)	(94,411)	(22,011)
<b>Net cash from operating activities</b>	<b>1,523,161</b>	<b>1,162,400</b>	<b>684,916</b>
<b>CASH FLOWS USED IN INVESTING ACTIVITIES:</b>			
Purchases of intangible fixed assets	(257,314)	(1,372,058)	(329,064)
Purchases of tangible fixed assets	(379,923)	(1,128,118)	(1,434,875)
Proceeds from short-term investments	91,456	199,699	193,959
Proceeds from sale of equipment and intangibles	18,344	25,250	14,905
<b>Net cash used in investing activities</b>	<b>(527,437)</b>	<b>(2,275,227)</b>	<b>(1,555,075)</b>
<b>CASH FLOWS (USED IN)/FROM FINANCING ACTIVITIES:</b>			
(Repayment of)/net proceeds from Bank Credit Facilities	(322,201)	1,288,594	
Repayment of Loan Facility		(836,158)	(248,643)
(Redemption of)/proceeds from the Notes	(655,622)	704,141	
Net change in overdraft facility	12	(36,342)	36,342

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Additional paid-in capital, net			16,827
<b>Net cash (used in)/from financing activities</b>	<b>(977,811)</b>	<b>1,120,235</b>	<b>(195,474)</b>
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>17,913</b>	<b>7,408</b>	<b>(1,065,633)</b>
<b>Effect of foreign exchange changes on cash and cash equivalents</b>	<b>(12)</b>	<b>(362)</b>	<b>(411)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>36,511</b>	<b>29,465</b>	<b>1,095,509</b>
<b>Cash and cash equivalents at end of period</b>	<b>54,412</b>	<b>36,511</b>	<b>29,465</b>

The accompanying notes are an integral part of these consolidated financial statements.

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## POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES

## Consolidated Statements of Changes in Equity

for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)

	Share Capital	Additional paid-in capital	Hedge reserve	Accumulated profit/(loss)	Total
<b>Balance as at January 1, 2000 (restated)</b>	<b>471,000</b>			<b>(303,194)</b>	<b>167,806</b>
Additional paid-in capital		409,754			409,754
Net profit for the period				109,387	109,387
<b>Balance as at December 31, 2000 (restated)</b>	<b>471,000</b>	<b>409,754</b>		<b>(193,807)*</b>	<b>686,947</b>
<b>Balance as at January 1, 2001</b>	<b>471,000</b>	<b>409,754</b>		<b>(193,807)*</b>	<b>686,947</b>
Effect of adopting IAS 39				(21,468)	(21,468)
Fair value losses on cash flow hedge, net of tax			(96,955)		(96,955)
Net profit for the period				427,221	427,221
<b>Balance as at December 31, 2001</b>	<b>471,000</b>	<b>409,754</b>	<b>(96,955)</b>	<b>211,946</b>	<b>995,745</b>
<b>Balance as at January 1, 2002</b>	<b>471,000</b>	<b>409,754</b>	<b>(96,955)</b>	<b>211,946</b>	<b>995,745</b>
Cash flow hedge:					
net fair value loss, net of tax reclassified and reported in net profit			(17,717)		(17,717)
deferred tax on reclassified item			30,210		30,210
deferred tax change in rates			(8,459)		(8,459)
Net profit for the period			6,272	346,476	346,476
<b>Balance as at December 31, 2002 (unaudited)</b>	<b>471,000</b>	<b>409,754</b>	<b>(86,649)</b>	<b>558,422</b>	<b>1,352,527</b>

\*The amount of PLN 193,807 representing accumulated deficit as at January 1, 2001 includes PLN 11,736 (decrease of accumulated deficit) of the revenue recognition retrospective adjustment (see Note 3.1).

The accompanying notes are an integral part of these consolidated financial statements.



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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**1. Incorporation and Principal Activities**

Polska Telefonia Cyfrowa Sp. z o.o. (the Company) is located in Warsaw, Al. Jerozolimskie 181 and was incorporated by the Notarial Deed dated December 20, 1995 and entered on the National Court Register kept by District Court in Warsaw, XIX Economic Department of National Court Register, Entry No. KRS 0000029159.

The principal activities of the Company are providing cellular telephone communication services in accordance with the GSM 900 and 1800 licenses granted by the Minister of Communications and the sale of cellular telephones and accessories compatible with its cellular services. On December 20, 2000 the Minister of Communications granted the Company a license to provide telecommunication services according to the Universal Mobile Telecommunication System (UMTS) standard. The UMTS services should be implemented in 2004 (see Notes 2, 3.5 and 15).

The principal activities of the Company are not seasonal or cyclical.

***Authorization of the consolidated financial statements***

These consolidated financial statements have been issued by the Board of Directors on February 7, 2003.

**2. Significant events in the year 2002**

On April 24, 2002 the Company received a decision from the President of Office for Telecommunication and Post Regulation (OTPR) confirming the postponement of the UMTS services launch deadlines by 12 months. According to this decision the Company is obliged to start rendering the UMTS services not earlier than on January 1, 2004 and not later than on January 1, 2005.

Following amendments to the Bank Credit Facilities (signed in May 2002 and allowing the Company to use the facilities for redemption of part of the Notes) on June 18, 2002 the General Shareholders' Assembly accepted a plan to redeem part of the Notes. In August 2002 the Company called part of its 10 3/4% Notes and repurchased part of its EUR 11 1/4% Notes and part of 10 7/8% Notes (see Note 19a).

On October 23, 2002 the Antimonopoly Court rejected the claim of Telekomunikacja Polska S.A. (TP SA) (Polish biggest fixed line operator) against OTPR's decision from May 28, 2001 on setting rates paid to the Company from international calls going through TP SA's network and terminating in the Company's network (see also Note 4).

On November 30, 2002 the Polish Parliament issued an act increasing corporate income tax rates from 24 and 22 percent for 2003 and the consecutive years, respectively to 27 percent. The change caused an increase in net deferred tax liability decreasing net income for the year ended December 31, 2002.

On November 30, 2001, the President of OTPR issued a decision, which lowered mobile to fixed interconnection rates by approximately 67 percent. TP SA appealed this decision to the Antimonopoly Court. On November 6, 2002 the Antimonopoly Court upheld TP SA's appeal stating that the justification for the new level of rates set by OTPR was insufficiently detailed. From November 6, 2002 the Company used the rates effective before November 30, 2001.

On December 24, 2002 the Company signed an annex to interconnect agreement with TP SA, which contractually lowered mobile to fixed interconnect rates by over 60%. The lowered rates were effective from January 1, 2002. The annex also set reductions in TP SA's fixed to mobile tariffs and set reduction of rates for TP SA's clients calling to the Company's network to be effected in 2003.

All the effects of changes in interconnect rates were accounted for in the accompanying financial statements.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**3. Principal Accounting Policies**

**3.1. Basis of preparation**

The Company maintains its accounting books in accordance with accounting principles and practices employed by enterprises in Poland as required by Polish Accounting Standards ( PAS ). The accompanying consolidated financial statements reflect certain adjustments not reflected in the Company s statutory books to present these statements in accordance with standards issued by the International Accounting Standards Board.

The consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of financial assets and financial liabilities held for trading or designated as hedging items.

The preparation of consolidated financial statements in conformity with International Financial Reporting Standards ( IFRS ) requires to use estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Although these estimates are based on Management s best knowledge of current event and actions, actual results ultimately may differ from these estimates.

The differences between IFRS and generally accepted accounting principles in the United States ( US GAAP ) and their effect on net results for the years ended December 31, 2002, 2001 and 2000 have been presented in Note 29 to these consolidated financial statements.

The IFRS rules that were mandatory as at December 31, 2002 were applied to these consolidated financial statements.

The Company adopted IAS 39 Financial Instruments: Recognition and Measurement ( IAS 39 ) and revenue recognition policy for multiple-element transactions based on SAB 101 Revenue Recognition in Financial Statements ( SAB 101 ) in 2001. The financial effects of adopting these standards were reported in the previous year s consolidated financial statements.

**3.2. Group Accounting**

These consolidated financial statements include the financial statements of Polska Telefonia Cyfrowa Sp. z o.o. and its wholly owned subsidiaries, PTC International Finance B.V. and PTC International Finance (Holding) B.V. (consolidated).

All intercompany balances and transactions are eliminated in consolidation.

On June 17, 1997, PTC International Finance B.V. was incorporated under the laws of the Netherlands for the purpose of issuing long-term Notes. The Company acquired 40 fully paid shares with a par value of 1,000 Netherlands Guilders each, issued by PTC International Finance B.V. PTC International Finance B.V. has no subsidiaries on its own.

On November 5, 1999 PTC International Finance II S.A. was incorporated under the laws of Luxembourg and on November 16, 1999, PTC International Finance (Holding) B.V. was incorporated under the laws of the Netherlands for the purpose of issuing long-term Notes. The Company acquired 40 fully paid shares with a par value of 1,000 Netherlands Guilders each, issued by PTC International Finance (Holding) B.V.

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Additionally, the Company acquired 125 fully-paid shares with a par value of EUR 1,000 each issued by PTC International Finance II S.A. and contributed all of its shares except one, (owned by the Company, but held locally, due to legal requirements) to PTC International Finance (Holding) B.V. in exchange for 1 additional share of PTC International Finance (Holding) B.V. thus, PTC International Finance II S.A. became a fully owned subsidiary of PTC International Finance (Holding) B.V. PTC International Finance II S.A. has no subsidiaries of its own.

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**3. Principal Accounting Policies (Continued)****3.3. Measurement Currency**

The Company generates and expends cash through its operating activities mostly in Polish zloty ( PLN ). The majority of the Company's receivables, large part of its short-term liabilities and some of long-term liabilities are PLN denominated. Therefore, the Management has designated the PLN as the reporting (functional) currency of the Company. The accompanying consolidated financial statements are reported in thousands of PLN (unless otherwise noted).

**3.4. Property, plant and equipment**

Property, plant and equipment are shown at historical cost less accumulated depreciation.

The costs of property, plant and equipment include borrowing costs—interests and foreign exchange differences to the extent that they are regarded as an adjustment to interest resulting from payments or valuation of liabilities financing the relevant property, plant and equipment acquisition or construction.

Repairs and maintenance are charged to the income statement during the financial period in which they are incurred. The cost of major renovations is included in the carrying amount of the asset when it is expected that future economic benefits in excess of the originally assessed standard of performance of the existing asset will flow to the Company. The renovations are depreciated over the remaining useful life of the related asset.

Depreciation is calculated using the straight-line method over the estimated useful life of the assets. The following depreciation rates have been applied:

	Annual rate in %	Estimated Useful Lives in years
Buildings under capital lease	2.5%	40
Other buildings	4.0%	25
Plant and equipment	10.0 - 33.0%	3 - 10
Motor vehicles	12.5 - 30.0%	3 - 8
Other	10.0 - 30.0%	3 - 10
Leasehold improvements (operating lease)		lease term
Land	not depreciated	

Where carrying amount of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with carrying amount and are included in operating profit.

Effective January 2002 the Company changed prospectively the expected useful lives for part of network fixed assets (plant and equipment, part of other buildings) and non-network other fixed assets (i.e. modems, UPS equipment and other).

Changes in depreciation rates were as follows:

	<u>from</u>	<u>to</u>
network fixed assets	4.0 - 12.5%	10.0 - 25.0%
non-network other fixed assets	10.0 - 20.0%	12.5 - 33.0%

If the new rates had been applied for the years ended December 31, 2001 and 2000, the depreciation expense for those periods would have increased by PLN 80,870 and PLN 53,694, respectively.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**3. Principal Accounting Policies (Continued)**

**3.5. Intangible Fixed Assets**

*Licenses*

Intangible fixed assets include three licenses (GSM 900, GSM 1800 and UMTS licenses), which the Company acquired from the Polish State. Telecommunication licenses are measured at cost less accumulated depreciation. As the payments are deferred beyond normal credit terms the cost of license is the cash price equivalent. The difference between this amount and total payments is recognized as interest expense over the period of credit unless it is capitalized on the license value during its development period. The cost of UMTS license includes also interests on liabilities financing the license acquisition and foreign exchange differences to the extent that they are regarded as an adjustment to interest. The licenses are amortized using the straight-line method over the periods of their validity, i.e. GSM 900 license over 14.5 years (173 months), GSM 1800 license over 14.5 years (174 months) and UMTS license will be amortized over the period of usage from the date of the operational start-up of the underlying services. For further disclosure see Note 15.

*Computer software*

Costs associated with maintaining computer software programmes are recognized as an expense as incurred. Costs that are directly associated with development of identifiable and unique software products controlled by the Company and that will probably generate economic benefits exceeding costs beyond one year, are recognized as intangible assets.

Expenditure which enhances or extends the performance of computer software programmes beyond their original specifications is recognized as a capital improvement and added to the original cost of the software.

Computer software development cost recognized as assets are amortized using the straight-line method over their useful lives which is from 2 to 5 years for office software and from 1.2 to 10 years for network software.

*Other intangible assets*

Expenditure to acquire patents, trademarks and licences other than telecommunication licenses is capitalized and amortized using the straight-line method over their useful life, but not exceeding 10 years.

**3.6. Impairment of long-lived assets**

Property, plant and equipment and intangible assets are reviewed for impairment losses whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognized for the amount by which the carrying amount of the assets exceeds its recoverable amount which is the higher of an asset's net selling price and value in use.

Recoverable amount is estimated for an individual asset or, if it is not possible to do so, it is determined for cash-generating unit to which asset belongs.

**3.7. Debtors**

Amounts due from debtors are measured at cost net of provisions for doubtful accounts. The provisions are based on specific amounts due where realization is unlikely and on a general basis, calculated using historic collection experience.

**3.8. Inventories**

Inventories are stated at the lower of cost and net realizable value. The cost of inventories is principally assigned by using weighted average cost formulas.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**3. Principal Accounting Policies (Continued)**

**3.8. Inventories (Continued)**

The Company writes down the cost of inventories to net realizable value by setting adequate provisions netted with the related inventory balance. The costs of inventories become unrecoverable if those inventories are damaged, become wholly or partially obsolete or if their selling price declines.

The current or planned promotions do not affect provisions for handset inventory.

**3.9. Leasing**

The Company acquired its head-office premises under finance lease conditions and initially recognized assets and liabilities in the balance sheet at amounts equal to the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the Company's incremental borrowing rate was used.

The interest element of the leasing finance cost is charged to the income statement over the lease period so as to produce a constant periodic interest rate on the remaining balance of the liability for each period.

The finance lease liability was initially measured at an amortized cost. After the bifurcation of embedded derivative (Index swaps see Notes 3.14 and 23) it has two components: main liability measured at amortized costs and the indexing (embedded derivative) measured at fair value. See also Property, plant and equipment held under capital lease in Note 14, Finance lease in Note 19c.

**3.10. Borrowings**

**a. Notes**

The Company is full and unconditional guarantor of the Notes issued by its subsidiaries (see Note 19a). The Notes were recognized at fair value of consideration received less transaction costs plus call options initial value. They are amortized according to effective interest rates. Any difference between proceeds (net of transaction costs) and the redemption value including the initial value of options, if bifurcated, is recognized in the income statement over the period of the borrowings.

**b. Bank Credit Facility**

Bank Credit Facility was initially recognized at the proceeds received and is subsequently recorded at costs plus accrued interest (see Note 19b). Transaction costs attributable to Bank Credit Facility are classified as intangible assets.

**3.11. Advertising expense**

The Company charges the cost of advertising to expense as incurred.

**3.12. Deferred income tax**

Deferred income tax is calculated using the balance sheet liability method. Under the balance sheet liability method the expected tax effects of temporary differences are determined using enacted tax rates and reported

either as liabilities for taxes payable or assets representing the amounts of income taxes recoverable in future periods in respect of deductible temporary differences and the carry forward of unused tax losses and credits. Temporary differences are the differences between the carrying amount of an asset or a liability in the balance sheet and its taxable base.

Deferred tax assets are recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized.

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**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**3. Principal Accounting Policies (Continued)**

**3.13. Provisions**

Provisions are recognized when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.

**3.14. Derivatives**

Derivative financial instruments are initially recognized in the balance sheet at cost and subsequently are remeasured at their fair value. The Company recognizes derivatives embedded in the host contracts and account for them as separate derivatives if economic characteristics and risks of the derivative are not closely related to the host contract.

The gain or loss resulting from remeasurement of derivatives to fair value is recognized in the income statement in the period they occur, unless the derivative is designated to hedge accounting.

The Company designates certain derivatives as hedge of the fair value of a recognized asset or liability (fair value hedge) or hedge of a forecasted transactions (cash flow hedge) (see Note 5a). Changes in the fair value of derivatives that are designated and qualify as fair value hedges and that are highly effective, are recorded in the income statement, along with any changes in the fair value of the hedged asset or liability that is attributable to the hedged risk.

Changes in the fair value of derivatives that are designated and qualify as cash flow hedges and that are highly effective are recognized in shareholders' equity, net of tax effect. Amounts deferred in shareholders' equity are transferred to the income statement and classified as financial income or expense in the period when the hedged forecasted transactions accrue in the income statement.

Derivatives that are designated as cash flow hedges are regularly reviewed for the effectiveness and the gain or loss relating to the ineffective portion of the derivatives is recognized in the income statement immediately.

A derivative financial asset (or its portion) is derecognised if the Company loses control of the contractual rights that comprise the derivative financial asset (or its portion). A derivative financial liability (or its part) is removed from its balance sheet when, and only when, it is extinguished—that is when the obligation specified in the contract is discharged, cancelled, or expires. For further disclosure see Note 23.

**3.15. Measurement base for financial assets and liabilities**

The fair value of derivatives held for trading is based on quoted market price at the balance sheet date. The fair value of cross-currency interest rate swaps is calculated as the present value of estimated future cash flows. The fair value of forward foreign exchange contracts is determined using forward exchange market rates at the balance sheet date.

In assessing fair value of non-traded derivatives and other financial instruments, the Company uses a variety of methods and makes assumptions that are based on market conditions existing at each balance sheet date. Option pricing models and estimated discounted value of future cash flows are used to determine fair value of options split from the Notes and derivatives split from trade contracts.

All regular way purchases of financial assets are accounted for at the trade date.

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**3. Principal Accounting Policies (Continued)****3.15. Measurement base for financial assets and liabilities (Continued)**

The table below presents the measurement categorization of financial assets and liabilities

<b>Category</b>	<b>Balance sheet item</b>	<b>Measurement</b>
<i>Financial assets</i>		
Held for trading	Cash and cash equivalents, Derivatives: forward contracts, Note options, Index swaps	Fair value Fair value model using market data
Held to maturity	Short-term investments	Amortized cost
Loans and receivables originated by the Company	Trade and other debtors	Original recorded cost
Hedging derivatives	Cross-currency interest rate swaps	Fair value model using market data
<i>Financial liabilities</i>		
Held for trading	Forward contracts	Fair value model using market data
	Index swaps	Fair value model using market data
Non-trading liabilities	License liabilities	Amortized cost
	Construction payables	Original recorded cost
	Trade and other creditors	Original recorded cost
	Long-term Notes	Amortized cost
	Finance lease	Amortized cost
	Bank Credit Facilities	Costs plus accrued interest
	Overdrafts	Costs plus accrued interest
	Accruals	Original recorded cost
Hedging derivatives	Cross-currency interest rate swaps	Fair value model using market data

**3.16. Revenue recognition**

Net sales consist of the value of sales (excluding value added tax) of goods and services in the normal course of business but exclude extraordinary disposals of inventory and other assets. Revenue is recognized when services are provided or goods are shipped out. Sales allowances are accounted in the same period when the related portion of revenue is recognized.

The Company set criteria for recognition of multiple-element transactions and their presentation in the IFRS consolidated financial statements as initiated by SAB 101 and further interpretations (see Note 3.1).

The multiple-element transactions with post-paid clients are classified as separable or non-separable contracts whereas the prepaid services are treated as separable transactions. The initial revenue from a multiple-element arrangement that is non-separable (handset price and activation fee) is deferred and recognized ratably over the average expected life of the customer. The direct cost of a product sold in this contract is also deferred in line with the revenue. The initial excess of cost over the revenue is immediately expensed. The revenue from separable multiple-element transactions and costs related to these transactions are recognized in the income

statement as incurred.

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
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**3. Principal Accounting Policies (Continued)****3.16. Revenue recognition (Continued)**

The accounting treatment of revenues and relevant costs for multi-element arrangements is summarized in the following table:

**Multi-element contract (handset, activation and telecommunication service)**

	<b>Separable</b>	<b>Non-separable</b>
Accounting treatment	Activation represents up-front non-refundable fee. Handset is sold separately from the rest of the multi-element contract	Handset, activation and service are treated as multi-element contract that is non-separable.
Revenue recognition	Activation and handset revenue is recognized immediately.	<i>Multiple Element Revenue:</i> Activation and handset revenue is deferred over average expected life of the customer.
Cost recognition	Cost of the activation card and handset is recognized immediately.	<i>Multiple Element Cost:</i> Cost of activation card and cost of handset equal to activation and handset revenue is deferred over average expected life of the customer. The excess of the costs over revenues is immediately expensed.

Total sales price of handsets sold together with prepaid service cards is allocated on a pro-rata basis based on the relative fair value of the elements.

**3.17. Transactions in foreign currencies**

Foreign currency transactions are translated into measurement currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from settlement of such transactions and from translation of monetary assets and liabilities denominated in foreign currencies using exchange rates prevailing at the end of the reporting period, are recorded in the income statement, except when capitalized to cost of qualifying assets.

The financial statements of the Company's subsidiaries as being integral to the Company's operations are translated using the same standards and procedures as if the transactions had been those of the Company itself.

Starting January 1, 2002 the Company changed foreign exchange rules used for measurement of assets and liabilities denominated in foreign currencies. The assets are translated using the bid foreign exchange rates and the liabilities are translated using the offer foreign exchange rates of the dominant bank serving the Company. The rules are not applied to the contracts denominated in foreign currencies containing specific clauses regarding translation.

The change was initiated by the changes in PAS due to amendments enacted in the Polish Accounting Act. The Company has decided to apply those more precise rules under IFRS.

**3.18. Capitalization of borrowing costs**

Borrowing costs (including interest, foreign exchange gains and losses to the extent that they are regarded as an adjustment to interest, and the discount relating to the present value of license payments) that are attributable to the acquisition, construction or production of qualifying assets are capitalized as a part of the

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**3. Principal Accounting Policies (Continued)**

**3.18. Capitalization of borrowing costs (Continued)**

cost of those assets. The borrowing costs capitalized are only those incurred during the period of construction or production of qualifying assets.

**3.19. Comparatives**

Where necessary, comparative figures have been reclassified to conform with changes in presentation in the current year. The reclassifications were not significant and did not affect the income statements.

**3.20. Capital**

Additional paid-in capital is classified in the equity as the probability of its payback to the shareholders is low and depends on certain law and contractual restrictions.

**4. Events after the balance sheet date**

On January 20, 2003 the Company has been informed that TP SA lodged cassation to the Supreme Court against the Antimonopoly Court's judgement relating international traffic rates terminating in the Company's network. Management supported by an independent legal counsel assesses the situation as causing contingent liability as the probability that the Supreme Court will accept the cassation and cancel the Antimonopoly Court's judgement is little (see also Note 2).

**5. Financial risk management**

The Company's treasury function is responsible for managing financial risk in accordance with the Company's hedging policy. Principle exposures and methods used by the Company to mitigate those exposures are described below.

The hedging policy approved by the Supervisory Board provides principles for overall financial risk management in the Company. This policy sets a framework within which the hedging activity should operate. However, it also allows some discretion in the precise hedging strategy to be adopted, to allow the treasury function to react to market conditions. According to the hedging policy, each year the treasury function prepares a hedging strategy regarding transaction risk, which is later submitted to the Management Board and Supervisory Board.

The ultimate responsibility for agreeing the details of the annual hedging strategy rests with the Management Board and the Supervisory Board based on the recommendations of the Risk Management Committee consisting of the CFO, the Treasurer, the Controller and the Tax Manager. The responsibility for the execution of foreign exchange and interest rate hedge transactions, within the agreed strategy and in conformity with the hedging policy, rests with the treasury function of the Company. On the other hand, the Management Board and the Supervisory Board must approve any actions taken to hedge transaction risk.

**a. Foreign exchange risk**

A significant proportion of the financing liabilities of the Company is denominated in foreign currencies (EUR and USD). The financial risk management is aimed both at minimizing the volatility of cash flows, in PLN

terms, arising from fluctuations in the exchange rate of the PLN against other currencies and at minimizing the adverse effect of movements in exchange rates on the earnings and book value of the Company in PLN terms.

The treasury function manages the foreign exchange exposure based on forecasts of cash flows denominated in foreign currencies. These forecasts distinguish between forecasts of cash flows where there is significant certainty as to both the amount and timing of the cash flow ( Committed Exposures ) and those where there is some uncertainty about the amount and/or timing of the cash flow ( Uncommitted Exposures ).

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**5. Financial risk management (Continued)**

**a. Foreign exchange risk (Continued)**

Hedge activities are undertaken on the basis of short- to long-term cash flow forecasts provided by treasury function and business units of the Company. The Company normally seeks to cover Committed Exposures by range of means agreed by the Management Board and the Supervisory Board on at least an annual basis, providing hedging can be obtained at acceptable cost. The Company may undertake actions to cover individually identified Uncommitted Exposures providing they are in compliance with hedging policy and constitute an integral part of annually accepted hedging strategies.

The Company does not speculate in foreign currency. Speculation is defined as taking any action to increase an exposure beyond that which exists due to an underlying commercial activity, in the expectation of making a foreign currency gain.

Foreign exchange risk management transactions of the Company may be undertaken using the following instruments:

forward and non-delivery forward transactions ( NDF contracts/ transactions ),

currency swaps,

cross-currency interest rate swaps ( CC swaps ),

foreign exchange options.

The Company hedges its long-term foreign exchange exposure arising from coupon payments on EUR and USD denominated Notes by concluding CC swaps (see Notes 3.14 and 23).

The Company hedges its medium-term foreign exchange exposure arising from possible repayments of a part of principal on EUR denominated Notes on the respective first call dates by concluding foreign exchange forward subordinated to Bank Credit Facilities (see Notes 19b and 23).

In respect of short-term hedging the Company entered into a series of foreign exchange forward and NDF contracts together with foreign exchange options to reduce volatility of current operating and financial cash flows resulting from foreign exchange rate fluctuations (see Note 23).

The Company applied hedge accounting to its long-term and medium-term activities and did not apply hedge accounting to short-term contracts.

**b. Interest rate risk**

The Company is exposed to interest rate risk related to short- and long-term credit facilities. Interest rate risk exposure arises from external financing denominated both in domestic and foreign currencies. The Company's interest bearing liabilities are based on fixed and floating interest rates.

Debt liabilities outstanding as at December 31, 2002 based on fixed interest rate are as follows (see Note 19a):

the 10 3/4 Notes with a face value of USD 126,215,000

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the 11 1/4 Notes with a face value of USD 150,000,000

the 11 1/4 Notes with a face value of EUR 282,750,000

the 10 7/8 Notes with a face value of EUR 187,500,000

Debt liabilities based on floating interest rates consist of Bank Credit Facilities (see Note 19b). The Company may utilize all facilities by individual drawdowns for the maturity of one, three, six or twelve months. The interest rate related to each drawdown is determined at the drawdown date and fixed for the maturity of the respective drawdown.

The interest rate exposure consists of a risk of increasing short-term interest rates, which would result in higher financing costs. Interest rate exposure also arises from the possibility of decreasing long-term interest

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**5. Financial risk management (Continued)**

**b. Interest rate risk (Continued)**

rates that would result in relative increase of financing costs versus market yields. The Company has limited risk of such a scenario by series of prepayment options embedded into all Notes ( Note options ).

The Company's interest rate exposure is managed by:

varying the maturity periods of investments and borrowings,

varying the proportions of debt which bears interest on a fixed and a floating basis,

varying the period of time for which the interest rate is fixed in respect to the Bank Credit Facilities.

In addition to the interest rate management tools described above, the Company may, in line with its hedging policy enter into the following interest rate hedging transactions:

forward rate agreements (FRAs),

interest rate swaps,

interest rate options (caps, floors, collars).

**c. Credit risk**

***Commercial credit risk***

The Company operates in one industry segment, providing cellular telephone communication services. Substantially all of the Company's trade debtors are Polish businesses and individuals. Further, the Company has established a network of dealers within Poland to distribute its products. The dealers share many economic characteristics thus receivables from each of these dealers present similar risk to the Company.

Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising the Company's customer base.

The Company maintains provisions for potential credit losses and such losses in the aggregate, have not exceeded Management's expectations. With the exception of TP SA, which purchases terminating interconnection services from the Company, no single customer accounts for 10% or more of revenues.

The balance of receivables as at December 31, 2002, representing the total net commercial credit risk exposure as at this date, is presented in Note 12.

***Financial credit risk***

There is a risk that the counterparties may be unable to meet their obligations related to financial instruments. This credit risk is monitored and measured by the treasury function in the Company. In order to minimize the risk the Company limits its counterparties to a sufficient number of major banks and financial institutions with high financial ratings.

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The balance of financial assets, short-term investments and other financial assets as at December 31, 2002, representing the total financial credit exposure, is presented in Notes 11 and 16.

### 6. Net sales

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Service revenues and fees	4,753,445	4,123,555	3,460,579
Sales of telephones and accessories	176,379	221,341	224,144
	4,929,824	4,344,896	3,684,723

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**6. Net sales (Continued)**

The Company operates in one segment (providing cellular telecommunication services and the ancillary sale of cellular telephones and accessories) and in one market (the Republic of Poland). The main sources of the Company's revenue are airtime tariffs, consisting primarily of monthly service fees (from incoming and outgoing calls), and charges for calls that originate or terminate in the Company's network, and calls placed by the Company's subscribers on foreign networks (roaming calls).

**7. Costs and expenses**

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Cost of sales:			
Cost of services sold	2,018,636	1,778,687	1,383,893
Cost of sales of telephones and accessories	970,557	948,750	902,533
	<u>2,989,193</u>	<u>2,727,437</u>	<u>2,286,426</u>
Operating expenses:			
Selling and distribution costs	545,404	585,463	576,318
Administration and other operating costs	244,711	199,966	189,698
	<u>790,115</u>	<u>785,429</u>	<u>766,016</u>
	<u><b>3,779,308</b></u>	<u><b>3,512,866</b></u>	<u><b>3,052,442</b></u>

Costs and expenses include research and development costs that were expensed when incurred. The research and development costs were immaterial in the above periods.

The rental expenses included in costs and expenses amounted to PLN 147,133, PLN 129,053 and PLN 102,868 for the years ended December 31, 2002, December 31, 2001 and December 31, 2000, respectively.

The following costs and expenses were included in cost of sales:

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
External services	1,083,417	869,995	895,452
Merchandise sold	969,642	949,805	815,227
Depreciation and amortization	822,993	790,796	476,011
Staff costs	80,626	81,315	71,091
Other	32,515	35,526	28,645

<u>2,989,193</u>	<u>2,727,437</u>	<u>2,286,426</u>
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The following costs and expenses were included in selling and distribution costs:

	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>	<u>Year ended December 31, 2000</u>
	(unaudited)		(restated)
External services including advertising costs	252,651	292,367	259,124
Staff costs	183,887	158,700	127,043
Depreciation and amortization	58,441	40,213	22,491
Other including bad debt expense	50,425	94,183	167,660
	<u>545,404</u>	<u>585,463</u>	<u>576,318</u>



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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**7. Costs and expenses (Continued)**

The following costs and expenses were included in administration costs:

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
External services	103,437	87,100	80,076
Staff costs	84,031	77,904	70,366
Depreciation and amortization	28,549	19,563	21,203
Other	28,694	15,399	18,053
	<u>244,711</u>	<u>199,966</u>	<u>189,698</u>

**8. Interest and other financial income**

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Gains on valuation of derivatives (see Note 23)	130,081	81,944	
Foreign exchange gains	119,191	207,911	185,195
Interest income	17,182	26,761	41,930
	<u>266,454</u>	<u>316,616</u>	<u>227,125</u>

**9. Interest and other financial expenses**

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Interest expense	446,673	496,300	543,510
Foreign exchange losses	344,551	54,020	105,271
Losses on valuation of derivatives (see Note 23)	50,115	144,226	67,884
Other financial expenses	6,793		
	<u>848,132</u>	<u>694,546</u>	<u>716,665</u>

**10. Taxation**

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Polish current tax benefit	402		802
Polish deferred tax charge	(220,744)	(25,460)	(33,186)
Foreign current tax charge	(2,020)	(1,419)	(970)
	<u>          </u>	<u>          </u>	<u>          </u>
Tax charge	<b>(222,362)</b>	<b>(26,879)</b>	<b>(33,354)</b>
	<u>          </u>	<u>          </u>	<u>          </u>

Tax loss carry forwards available as at December 31, 2002 amounted to PLN 513,552. The loss can be offset against taxable income, during the next four fiscal years after December 31, 2002 but no more than 50 percent of one year's tax loss carried forward.

According to the Polish tax regulations, the tax rates in effect in 2002 and 2001 were 28% for both years and 30% for year 2000. The tax rate for 2003 and following years is to be 27% (see Note 2).

**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**10. Taxation (Continued)**

The reconciliation between tax charge and the product of accounting profit or loss multiplied by the applicable statutory tax rates is as follows:

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Profit before taxation	568,838	454,100	142,741
Tax rate	28%	28%	30%
Tax charge using statutory rate	(159,274)	(127,148)	(42,822)
Non-taxable differences	(15,649)	12,309	(19,256)
Change in temporary differences for which realization is not probable	10,871	32,653	(712)
Effect of different tax rates and rules in foreign entities	803	1,881	4,685
Change in tax rates	(68,184)	51,803	23,343
Refiling of previous years tax return	402		802
Adjustments to deferred taxes	8,669	1,623	606
Tax charge	<b>(222,362)</b>	<b>(26,879)</b>	<b>(33,354)</b>

The deferred tax income credited to equity after reclassification a part related to CC swaps to the income statement was PLN 4,703 in 2002 and PLN 27,346 in 2001.

	Year ended December 31, 2002	Year ended December 31, 2001
	(unaudited)	
Deferred tax assets in Poland:		
Tax loss carry forward	138,659	227,661
Bad debt provision	71,524	82,807
Accrued interest	37,729	49,864
Unrealized foreign exchange loss, net	1,661	
Accrued expenses	51,040	52,672
Financial instruments, net	27,449	46,530
Inventory provision	9,094	7,398
Accrued advertising	5,677	7,847
	342,833	474,779
Temporary differences for which realization is not probable ( valuation allowance )	(46,568)	(54,585)

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	296,265	420,194
Deferred tax liabilities in Poland:		
Book versus tax basis of GSM/UMTS licenses	(498,295)	(386,037)
Book versus tax basis of fixed assets	(66,141)	(62,794)
Unrealized foreign exchange gain, net		(23,484)
	<u>          </u>	<u>          </u>
Net deferred tax liability	<b>(268,171)</b>	<b>(52,121)</b>
	<u>          </u>	<u>          </u>

The amounts of valuation allowance as at December 31, 2002 and December 31, 2001 consist primarily of the bad debt provision for which tax deductibility is yet uncertain.

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**11. Short-term investment and other financial assets**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Trade contract derivatives	8,445	6,822
Index swaps	3,698	
Treasury Bills		91,456
	<b>12,143</b>	<b>98,278</b>

Trade contract derivatives represent short-term portion of the derivatives separated from trade contracts (see also Notes 3.14 and 16).

Index swaps represent short-term portion of the derivatives bifurcated from Finance lease (see Notes 3.9, 3.14, 19c and 23).

The Treasury Bills represented short-term portion of US Treasury and German Treasury Bills which were a part of an escrow fund established to secure payment of interest on 11 1/4% Notes till June 1, 2002.

**12. Debtors and prepayments**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Trade debtors and accrued revenue	710,130	671,621
Prepaid expenses	18,412	19,541
Other debtors	10,427	19,078
Amounts due from State Treasury	2,213	11,908
Accounts receivable from shareholders	1,332	614
	742,514	722,762
Provision for doubtful debtors	(121,765)	(183,940)
	<b>620,749</b>	<b>538,822</b>

Movements of the provision for doubtful debtors is as follow:

As at December 31,	As at December 31,	As at December 31,
-----------------------	-----------------------	-----------------------

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	<u>2002</u>	<u>2001</u>	<u>2000</u>
	<b>(unaudited)</b>		
Opening balance	(183,940)	(221,821)	(166,834)
Increase	(86,333)	(138,842)	(170,748)
Write off	91,399	105,507	91,637
Release	57,109	71,216	24,123
	<u>          </u>	<u>          </u>	<u>          </u>
Closing balance	<b>(121,765)</b>	<b>(183,940)</b>	<b>(221,821)</b>
	<u>          </u>	<u>          </u>	<u>          </u>

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**13. Inventory**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Telephones	172,948	117,653
Network spare parts and accessories	95,353	75,884
	268,301	193,537
Inventory provision	(33,756)	(26,423)
	<b>234,545</b>	<b>167,114</b>

**14. Property, plant and equipment**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Land and buildings	224,546	186,473
Plant and equipment	2,544,135	2,821,953
Motor vehicles	17,343	18,800
Other fixed assets	537,254	548,470
Construction in progress	115,408	208,114
	<b>3,438,686</b>	<b>3,783,810</b>

During the year ended December 31, 2002 the Company capitalized PLN 5,459 of foreign exchange losses, PLN 10,127 of interest expense and PLN 504 of hedging expense and during the year ended December 31, 2001 the Company capitalized PLN 6,817 of foreign exchange gains, PLN 15,116 of interest expense and PLN 187 of hedging expense.

The effective capitalization rate used to determine borrowing costs to be capitalized was 19.0% in 2002 and 8.5% in 2001.

The movement in each year was as follows:

Land and Buildings	Plant and equipment	Motor vehicles	Other fixed assets	Construction in progress	Total
<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

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<b>Cost</b>						
As at January 1, 2001	200,062	3,293,697	28,727	468,801	201,122	4,192,409
Additions	35			8,881	912,561	921,477
Transfers		709,370	13,698	164,274	(887,342)	
Disposals		(7,450)	(7,204)	(10,930)	(18,227)	(43,811)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
As at December 31, 2001	200,097	3,995,617	35,221	631,026	208,114	5,070,075
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Depreciation</b>						
As at January 1, 2001	8,690	605,029	16,271	48,328		678,318
Charge	4,934	571,670	7,076	44,510		628,190
Transfer		1,108	5	(1,113)		
Disposals		(4,143)	(6,931)	(9,169)		(20,243)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
As at December 31, 2001	13,624	1,173,664	16,421	82,556		1,286,265
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net book value as at</b>						
<b>December 31, 2001</b>	<b>186,473</b>	<b>2,821,953</b>	<b>18,800</b>	<b>548,470</b>	<b>208,114</b>	<b>3,783,810</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
**(in thousands of PLN)**

**14. Property, plant and equipment (Continued)**

	<b>Land and Buildings</b>	<b>Plant and equipment</b>	<b>Motor vehicles</b>	<b>Other fixed assets</b>	<b>Construction in progress</b>	<b>Total</b>
<b>Cost</b>						
As at January 1, 2002	200,097	3,995,617	35,221	631,026	208,114	5,070,075
Additions	116			5,949	353,082	359,147
Transfers	46,492	325,242	7,412	61,973	(440,755)	364
Disposals		(82,363)	(4,683)	(2,677)	(5,033)	(94,756)
As at December 31, 2002	246,705	4,238,496	37,950	696,271	115,408	5,334,830
<b>Depreciation</b>						
As at January 1, 2002	13,624	1,173,664	16,421	82,556		1,286,265
Charge	5,989	582,906	8,528	78,523		675,946
Transfer	2,546	(3,016)		527		57
Disposals		(59,193)	(4,342)	(2,589)		(66,124)
As at December 31, 2002	22,159	1,694,361	20,607	159,017		1,896,144
<b>Net book value as at December 31, 2002 (unaudited)</b>						
	<b>224,546</b>	<b>2,544,135</b>	<b>17,343</b>	<b>537,254</b>	<b>115,408</b>	<b>3,438,686</b>

During year 2002 the Company performed a count of all network fixed assets. The final results of the count showed a surplus of PLN 1.9 million and a shortage of PLN 2.3 million (presented net as decrease of other cost of sales).

Property, plant and equipment held under capital leases without later improvements (included in the previous schedule):

	<b>As at December 31, 2002</b>			<b>As at December 31, 2001</b>		
	<b>Land</b>	<b>Buildings</b>	<b>Other</b>	<b>Land</b>	<b>Buildings</b>	<b>Other</b>
<b>(unaudited)</b>						
Cost	6,293	197,806	990	6,293	197,806	990
Accumulated depreciation		(18,848)	(338)		(13,903)	(240)
Net	6,293	178,958	652	6,293	183,903	750

As at January 1, 2002 the Company transferred the improvements made in leased buildings from Other fixed assets to Land and Buildings. As at December 31, 2002 gross value and accumulated depreciation of the

improvements amounted to PLN 41,430 and PLN 3,069, respectively.

#### 15. Intangible fixed assets

	As at December 31, 2002	As at December 31, 2001
	<u>                    </u>	<u>                    </u>
	<b>(unaudited)</b>	
GSM and UMTS licenses	2,335,836	2,143,111
Computer and network software	287,323	240,402
Trademark	118	132
Transaction costs	27,853	29,165
	<u>                    </u>	<u>                    </u>
	<b>2,651,130</b>	<b>2,412,810</b>
	<u>                    </u>	<u>                    </u>

During the year ended December 31, 2002 the Company capitalized to intangible fixed assets PLN 104,142 of foreign exchange losses, PLN 160,316 of interest expense and PLN 5,394 of hedging expenses and during the year ended December 31, 2001 the Company capitalized to intangible fixed assets PLN 101,873 of foreign exchange gains, PLN 153,808 of interest expense and PLN 1,428 of hedging expenses.

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**15. Intangible fixed assets (Continued)**

The effective annual capitalization rate for the whole period of capitalization from 2000 for external borrowing (i.e. excluding interest and foreign exchange rates from revaluation of UMTS license liability) was 15.8%.

The Company has no intangible assets generated internally.

The movement in each year was as follows:

	GSM & UMTS Licenses	Computer and network software	Trade Mark	Transaction costs	Total
<b>Cost</b>					
As at January 1, 2001	2,395,499	253,297	206		2,649,002
IAS 39 adjustments				16,553	16,553
As at January 1, 2001	2,395,499	253,297	206	16,553	2,665,555
Additions		222,168		34,254	256,422
Disposals		(6,524)		(15,670)	(22,194)
Capitalization of borrowing costs	53,363				53,363
As at December 31, 2001	2,448,862	468,941	206	35,137	2,953,146
<b>Amortization</b>					
As at January 1, 2001	228,624	106,147	60		334,831
IAS 39 adjustments				5,217	5,217
As at January 1, 2001	228,624	106,147	60	5,217	340,048
Charge	77,127	128,816	14	16,425	222,382
Disposals		(6,424)		(15,670)	(22,094)
As at December 31, 2001	305,751	228,539	74	5,972	540,336
<b>Net book value as at December 31, 2001</b>	<b>2,143,111</b>	<b>240,402</b>	<b>132</b>	<b>29,165</b>	<b>2,412,810</b>

	GSM & UMTS Licenses	Computer and network software	Trade Mark	Transaction costs	Total
<b>Cost</b>					
As at January 1, 2002	2,448,862	468,941	206	35,137	2,953,146

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Additions	197,480		7,913	205,393
Transfers	(364)			(364)
Disposals	(36,100)			(36,100)
Capitalization of borrowing costs	269,852			269,852
As at December 31, 2002	<u>2,718,714</u>	<u>629,957</u>	<u>206</u>	<u>43,050</u>
				<u>3,391,927</u>
<b>Amortization</b>				
As at January 1, 2002	305,751	228,539	74	5,972
Charge	77,127	150,157	14	6,739
Transfers		(57)		(57)
Disposals		(36,005)		(36,005)
Other				2,486
As at December 31, 2002 (unaudited)	<u>382,878</u>	<u>342,634</u>	<u>88</u>	<u>15,197</u>
				<u>740,797</u>
<b>Net book value as at December 31, 2002</b>	<b><u>2,335,836</u></b>	<b><u>287,323</u></b>	<b><u>118</u></b>	<b><u>27,853</u></b>
				<b><u>2,651,130</u></b>

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**15. Intangible fixed assets (Continued)**

*Licenses*

The balance of GSM and UMTS licenses consists of GSM 900, GSM 1800, UMTS and Lease line licenses acquired by the Company from the Polish State, represented by the Minister of Communications.

The GSM 900 license was acquired on February 23, 1996 and issued for a term of 15 years and allows the Company to apply for an extension for an agreed period one year prior to its expiration date together with a permit to install and utilize telecommunication equipment and network, and allocation of frequencies in the ETSI/GSM 900 MHz band. The Company was required to pay the Polish government a fee equal to the PLN equivalent of EUR 218 million, which was fully paid by December 31, 2001.

The GSM 900 license is subject to a number of commercial and technical conditions. While Polish law provides that the license may be revoked or limited in the event that the Company fails to meet any of these conditions, the Company believes that it is currently in compliance with all of the GSM 900 license conditions.

The GSM 1800 license was acquired on August 11, 1999 and has been in use since March 1, 2000. The Company was required to pay the Polish government a fee equal to the PLN equivalent of EUR 100 million, which was fully paid till December 31, 2002.

Similar to the GSM 900 license, the GSM 1800 license requires that the Company meets certain coverage and technical criteria, including a requirement that the dropped call rate does not exceed 5% during peak hours and that the Company attains geographical coverage combined with the 900 MHz and 1800 MHz frequencies of 90% by June 2004. The Company has already exceeded this level of coverage and complies with the dropped call rate criteria.

On September 29, 2000 the Minister of Communications granted the Company a license to lease the telecommunication lines in the Company's network, including a permit to install and utilize telecommunication equipment and network ( the Lease Lines License ). The Lease Line License is valid for 15 years from the date when it was delivered to the Company and has been valued at the nominal value as the license fee was paid in a single installment.

On December 20, 2000 the Minister of Communications granted the Company a license to provide telecommunication services according to the UMTS standard in the 2 GHz band, including a permit to install and utilize telecommunication equipment and network, and allocation of frequencies in the 2 GHz band ( the UMTS license ). The UMTS license is valid for 22 years from the date of acquisition. The Company is required to pay to the Polish government a fee equal to the PLN equivalent of EUR 650 million, which is payable in 22 installments. For further disclosure of liability balance see Note 19d.

The UMTS license requires the Company to attain 20% population coverage by the end of 2005 and 40% population coverage by the end of 2008 (see Note 2).

The above-described GSM 900 license, GSM 1800 license, UMTS license and the Lease Lines licenses are not transferable assets.

**16. Financial assets**

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	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Note options	127,029	82,860
Trade contract derivatives	38,207	23,125
Forward contracts	5,638	
CC swaps	414	
	<u>171,288</u>	<u>105,985</u>

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
**(in thousands of PLN)**

**16. Financial assets (Continued)**

Note options are prepayment options separated from the Notes. The increase in the balance compared to December 31, 2001 was mainly caused by an increase of Note market price (see also Notes 3.14 and 23).

Trade contract derivatives are separated from trade contracts denominated or linked to currency, which (i) is not the currency of the primary economic environment in which any substantial party to contract operates or (ii) is not a currency in which the price of the related good or service is routinely denominated in international commerce.

**17. Deferred costs and Other long-term assets**

	As at December 31, 2002	As at December 31, 2001
	<u>(unaudited)</u>	
Multiple-element transaction costs	76,011	69,523
Other	4,939	—
	<u>80,950</u>	<u>69,523</u>
Other long-term assets	1,141	4,600
	<u><b>82,091</b></u>	<u><b>74,123</b></u>

Multiple-element transaction cost represents the deferred costs from non-separable contracts (see Note 3.16).

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
**(in thousands of PLN)**

**18. Current liabilities**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	(reclassified)
<b>Accounts payable</b>		
Trade creditors	154,808	143,884
Construction payables	125,728	139,817
Accounts payable to shareholders	4,741	2,920
	<u>285,277</u>	<u>286,621</u>
<b>Amounts due to State Treasury</b>	<b>57,756</b>	<b>46,184</b>
<b>Interest-bearing liabilities</b>		
Interest accrued on Notes	76,483	47,428
Interest accrued on Bank Credit Facilities	26,557	60,729
Finance lease payable (see Note 19c)	18,070	21,802
Overdraft facilities	12	
GSM and UMTS licenses liability (see Note 19d)		55,747
Index swaps (see Notes 3.9, 3.14, 19c and 23)		4,723
	<u>121,122</u>	<u>190,429</u>
<b>Accruals (see Note 20)</b>	<b>185,569</b>	<b>123,686</b>
<b>Deferred income and other liabilities</b>		
Deferred income	153,100	123,005
CC swaps (see Notes 3.14 and 23)	43,051	5,909
Forward contracts (see Notes 3.14 and 23)	22,258	88,473
Social fund	3,603	2,920
Deposits from subscribers	1,969	3,815
Payroll	377	138
	<u>224,358</u>	<u>224,260</u>
	<u><b>874,082</b></u>	<u><b>871,180</b></u>

The social fund is an employer's obligation based on a government mandated calculation based on number of employees and the monthly minimum wage in Poland. The amounts calculated under this formula must be used for the benefits of the employees.



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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**19. Long-term liabilities**

	As at December 31, 2002	As at December 31, 2001
(unaudited)		
<b>Interest-bearing liabilities</b>		
Long-term Notes	2,950,039	3,258,680
Bank Credit Facilities	990,217	1,288,594
GSM and UMTS licenses liability	438,550	342,692
Finance lease payable	164,045	174,112
Index swaps (see Notes 3.9, 3.14, 19c and 23)	40,514	19,855
	<b>4,583,365</b>	<b>5,083,933</b>
<b>Non-interest-bearing liabilities</b>		
CC swaps (see Notes 3.14 and 23)	89,148	124,299
Multiple-element transaction revenue	76,011	69,523
	<b>165,159</b>	<b>193,822</b>
<b>Deferred tax liability</b> (see Note 10)	<b>268,171</b>	<b>52,121</b>
<b>Provisions for liabilities and charges</b> (see Note 20)	<b>21,740</b>	<b>20,652</b>
	<b>5,038,435</b>	<b>5,350,528</b>

**a. Notes**

The Company is full and unconditional guarantor of the following Notes issued by its subsidiaries. The net proceeds from the Notes were loaned to the Company.

	10 3/4% Notes	11 1/4% Notes	11 1/4% Notes	10 7/8% Notes
<b>Issuance date</b>	July 1, 1997	November 23, 1999	November 23, 1999	May 8, 2001
<b>Issuer</b>	PTC International Finance B.V.	PTC International Finance II S.A.	PTC International Finance II S.A.	PTC International Finance II S.A.
<b>Nominal value</b>	USD 126* million	EUR 283** million	USD 150 million	EUR 188*** million
<b>Coupon</b>	10 3/4	11 1/4	11 1/4	10 7/8
<b>Interest payment</b>	on each July 1 and January 1 from 2003	on each June 1 and December 1	on each June 1 and December 1	on each January 31 and July 31
<b>Maturity date</b>	July 1, 2007	December 1, 2009	December 1, 2009	May 1, 2008
<b>Registered</b>	in the United States (SEC)	in the United States (SEC);	in the United States (SEC);	in the United States (SEC);

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	Luxembourg Stock Exchange	Luxembourg Stock Exchange	Luxembourg Stock Exchange
<b>Market price as at December 31, 2002 (% of nominal value)</b>	105.00	106.00	107.00
<b>Carrying amount as at December 31, 2002 (including interest)</b>	517,385	1,145,862	575,586
			787,689

\* On August 20, 2002 the Company called 50.15% of 10 3/4% Notes of a principal amount of USD 126,988 thousand of its aggregated USD 253,203 thousand. The redemption price was 105.375% plus accrued interest. The holders of redeemed bonds were chosen by random selection.

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**19. Long-term liabilities (Continued)****a. Notes (Continued)**

\*\* In August 2002 the Company repurchased on the market 5.75% of the total principal amount of the 11 1/4% Notes of EUR 17,250 thousand. The principal amount of the repurchased Notes has been delisted from the Luxembourg Stock Exchange. The amount of EUR 282,750 thousand of the 11 1/4% Notes remain outstanding as at December 31, 2002 and continue to be listed on the Luxembourg Stock Exchange.

\*\*\* In August 2002 the Company repurchased on the market the principal amount of EUR 12,500 thousand of the 10 7/8% Notes (6.25% of the total principal amount). The principal amount of the repurchased Notes has been delisted from the Luxembourg Stock Exchange. The amount of EUR 187,500 thousand of the 10 7/8% Notes remain outstanding as at December 31, 2002 and continue to be listed on the Luxembourg Stock Exchange.

The total financial cost related to partial redemption of the 10 3/4% Notes and open market buy backs of EUR 11 1/4% Notes and 10 7/8% Notes amounted to PLN 33,679. At the same time the Company expensed the proportional parts of embedded derivatives to the respective Note call options in the amount of PLN 8,102.

The Company has right to the following call options embedded in the respective Notes:

	<u>10 3/4% Notes</u>	<u>11 1/4% Notes</u>	<u>10 7/8% Notes</u>
<b>Period 1</b>			
<b>Date</b>	July 1, 2002 - July 1, 2007	December 1, 2004 - December 1, 2009	May 1, 2005 - May 1, 2008
<b>Redemption amount</b>	in whole or in part	in whole or in part	in whole or in part
<b>Redemption price range</b>	105.375% - 100.00% of nominal value	105.625% - 100.00% of nominal value	105.438% - 100.00% of nominal value
<b>Period 2</b>			
<b>Date</b>	The Period 2 Issuer Call Option has not been exercised by the Issuer and expired in 2000.	The Period 2 Issuer Call Option has not been exercised by the Issuer and expired in the last quarter of 2002.	May 8, 2001 - May 1, 2004
<b>Redemption amount</b>			any amount up to 35% of the outstanding principal amount
<b>Redemption price range</b>			110.875% of nominal value

Fair value of the Notes call options is presented in Note 23.

The Notes have also the put options, which may be exercised (in any part) at 101% of nominal value by the Noteholders if a change of control event occurs. Change of control events are when: (1) if any person of group

becomes the beneficial owner of 50% or more of the total voting power except for Permitted Holders and as a consequence at least two notches decline in the rating of the Notes or the rating withdrawal, (2) substantially all the assets of the Company are sold or (3) certain changes in Supervisory Board.

**b. Bank Credit Facilities**

On February 20, 2001 the Company signed the two loan facility agreements ( Main Bank Facility Agreement amounting to EUR 550 million and Supplemental Bank Facility Agreement amounting to EUR 150 million (extended from EUR 100 million on September 21, 2001) together Bank Credit Facilities ) with the consortium of banks organized by Deutsche Bank AG London, Deutsche Bank Polska S.A., Dresdner Bank Luxembourg S.A. and the European Bank for Reconstruction and Development.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**19. Long-term liabilities (Continued)**

**b. Bank Credit Facilities (Continued)**

As at December 31, 2002 the balance outstanding under the Main Bank Facility Agreement amounted to PLN 990 million, which consisted in full of the domestic tranche (equivalent of EUR 257.5 million at the drawdown foreign exchange rate).

The main terms of the Main Bank Facility Agreement are as follows:

Facilities limits	equivalent of EUR 550 million available under two tranches: foreign exchange tranche amounting to EUR 292.5 million and domestic tranche of EUR 257.5 million available in PLN
Interests	LIBOR, EURIBOR, WIBOR plus negotiated margins
Collateral	pledge on the Company's assets and rights except for future real estates, the escrow fund for Notes and leased assets
Repayment date	quarterly reduction in facility limit starting from September 30, 2004 to February 20, 2006.

The main terms of the amended Supplemental Bank Facility Agreement are as follows:

Facilities limits	equivalent of EUR 150 million available under two tranches: foreign exchange tranche amounting to EUR 20 million and domestic tranche of EUR 130 million available in PLN
Interests	LIBOR, EURIBOR, WIBOR plus negotiated margins
Collateral	pledge on the Company's assets and rights except for future real estates, the escrow fund for Notes and leased assets
Repayment date	reduction in facility limit starting from September 30, 2005 to March 31, 2007.

As at December 31, 2002 the Supplemental Bank Facility was not drawn.

In addition under Bank Credit Facilities the Company is obliged to satisfy as at December 31, 2002 the following covenants:

Senior Debt to EBITDA\* at the level below 4.0:1.0

EBITDA to Interest Expense on Senior Debt at the level not less than 3.0:1.0

EBITDA to Interest Expense on Total Debt at the level not less than 2.0:1.0

As at the balance sheet date the Company met these covenants with comfortable margin.

**c. Finance lease**

On March 25, 1997 the Company entered into a finance lease agreement relating to its new headquarters building and underlying land ( Finance lease ). The headquarters lease obligation is denominated in USD and payable in PLN. The term of the lease is 15 years and the Company has a right to acquire the leased asset at the end of the lease not sooner than on April 30, 2013 and not later than by the July 31, 2013 (the value of the purchase option calculated as the leased space multiplied by the price per square meter amounts to USD 11,825).

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\* EBITDA is an operating profit increased by the amortization and depreciation expenses.

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**19. Long-term liabilities (Continued)****c. Finance lease (Continued)**

The minimum lease payments have been discounted at 11.338% (first building leased in second half of 1998) and at 11.174% (second building leased in July 1999), which approximated the Company's borrowing rate for USD as at the date of acquisition of the leased assets.

The timing and values of lease payments are presented below.

The future value payments under finance leases as at December 31, 2002 include future indexing of minimal lease payments.

**As at December 31, 2002 (unaudited)**

	<b>Future Value</b>	<b>Interest</b>	<b>Discounted with index swaps</b>	<b>Discounted</b>	<b>Index swaps</b>
Not later than 1 year	30,956	16,584	14,372	18,070	(3,698)
Later than 1 year and not later than 5 years	133,388	84,177	49,211	54,335	(5,124)
Later than 5 years	253,828	98,480	155,348	109,710	45,638
	<b>418,172</b>	<b>199,241</b>	<b>218,931</b>	<b>182,115</b>	<b>36,816</b>

**As at December 31, 2001**

	<b>Future Value</b>	<b>Interest</b>	<b>Discounted with index swaps</b>	<b>Discounted</b>	<b>Index swaps</b>
Not later than 1 year	31,208	4,683	26,525	21,802	4,723
Later than 1 year and not later than 5 years	134,480	64,481	69,999	61,394	8,605
Later than 5 years	299,760	175,792	123,968	112,718	11,250
	<b>465,448</b>	<b>244,956</b>	<b>220,492</b>	<b>195,914</b>	<b>24,578</b>

**d. License fee payables**

The fees for the Company's GSM 900, GSM 1800 and UMTS licenses were denominated in EUR and payable in installments. These deferred payments have been discounted at 6.78% (the GSM 900 license), at 9.52% (the

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GSM 1800 license) and at 12.06% for short-term and 12.11% for long-term installments (the UMTS license), which approximated the Company's borrowing rate for EUR as at the date of acquisition of the licenses. As at December 31, 2002 the fair value of the UMTS license liability amounted to PLN 442 million. The fair value was calculated as discounted future payments at current market interest rates. As at that date there was no GSM 900 or GSM 1800 license liability outstanding.

The maturity of license fee payable as at December 31, 2002 was as follow:

	<b>EUR 000 nominal</b>	<b>EUR 000 discounted</b>	<b>PLN 000 discounted</b>
Between 2 and 5 years	45,000	29,477	118,502
Over 5 years	345,000	79,610	320,048
	<b>390,000</b>	<b>109,087</b>	<b>438,550</b>

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**19. Long-term liabilities (Continued)****d. License fee payables (Continued)**

The maturity of license fees payable as at December 31, 2001 were as follow:

	EUR 000 nominal	EUR 000 discounted	PLN 000 discounted
Not later than 1 year (see Note 18)	16,716	15,829	55,747
Later than 1 year and not later than 5 years	30,000	18,509	65,187
Later than 5 years	360,000	78,794	277,505
	<b>406,716</b>	<b>113,132</b>	<b>398,439</b>

**20. Accruals and Provisions for liabilities and charges**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
<b>Accruals</b>	<b>185,569</b>	<b>123,686</b>
<b>Provisions for liabilities and charges</b>		
Provision for loyalty program		
Opening balance	20,652	12,908
Increase	13,498	15,144
Decrease	(12,410)	(7,400)
Closing balance	<b>21,740</b>	<b>20,652</b>

The balance of accruals includes mainly operating costs not invoiced and employee bonuses.

**21. Capital**

	As at December 31, 2002	As at December 31, 2001
	(unaudited)	
Allotted, called-up and fully paid:		
471,000 ordinary shares of PLN 1,000 each	471,000	471,000
Additional paid-in capital	409,754	409,754

880,754

880,754

**22. Related party transactions**

The below transactions consist primarily of roaming services rendered and received as well as consulting expenses.

Management believes that related party transactions were conducted primarily on market terms.

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**22. Related party transactions (Continued)**

	As at and for the year ended December 31, 2002	As at and for the year ended December 31, 2001	As at and for the year ended December 31, 2000
	(unaudited)		(restated)
<i>Elektrim S.A.</i>			
Inter-company receivables		93	132
Inter-company payables and accruals	25	23	224
Inter-company sales	310	741	839
Inter-company purchases	242	272	1,990
<i>Elektrim Telekomunikacja Sp. z o.o. ( ET )</i>			
Inter-company payables and accruals	368		
Inter-company sales	161	38	
Inter-company purchases	2,039		
<i>T-Mobile Deutschland GmbH, T-Mobile International AG ( T-Mobile )</i>			
Inter-company receivables	1,332	521	1,063
Inter-company payables and accruals	6,447	2,897	1,524
Inter-company sales	23,809	24,365	19,670
Inter-company purchases	24,866	22,128	22,246
<i>MediaOne International B.V. ( MediaOne )</i>			
Inter-company purchases		278	7,834

*Vivendi Telecom International ( Vivendi )*

There were no material transactions with Vivendi Telecom International.

**23. Derivative financial instruments**

Type of derivative	Forward and option contracts	Note options	CC swaps	Index swaps	Trade contract derivatives	Total
<b>Balance as at January 1, 2002 asset/(liability)</b>	<b>(88,473)</b>	<b>82,860</b>	<b>(130,208)</b>	<b>(24,578)</b>	<b>29,947</b>	<b>(130,452)</b>
Cash paid/(received) on realization	19,981		24,224	(4,565)	(6,667)	32,973
Changes in the fair value together with realization reported in the income statement	51,872	44,169	(31,404)	(7,673)	23,372	80,336
Changes in the fair value reported in shareholders equity (hedge reserve)			5,603			5,603
<b>Balance as at December 31, 2002</b>	<b>(16,620)</b>	<b>127,029</b>	<b>(131,785)</b>	<b>(36,816)</b>	<b>46,652</b>	<b>(11,540)</b>

asset/(liability)  
(unaudited)

██████████ ██████████ ██████████ ██████████ ██████████ ██████████

Forward contracts are used by the Company to hedge foreign exchange risk related to operational and financial transactions. The Company applies hedge accounting for financial transactions.

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**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**23. Derivative financial instruments (Continued)**

Maturity of forward contracts is as follow:

	<b>Currency</b>	<b>Notional value in currency</b>	<b>Carrying value asset/(liability)</b>
Within 1 year	EUR	240 million	(22,258)
Between 1 and 2 years	EUR	80 million	2,898
Between 2 and 5 years	EUR	60 million	2,740
			<b>(16,620)</b>

CC swaps are designated as hedges against exposure to changes in future cash flows arising from the foreign exchange risk on the future interest coupon payments.

<b>Issuance date</b>	<b>Notional in currency</b>	<b>Notional in PLN</b>	<b>PTC pays</b>	<b>PTC receives</b>	<b>Maturity date</b>
April 4, 2001	EUR 60 million	217,140	PLN 15.20%	EUR 11 1/4%	December 1, 2007
May 21, 2001	EUR 90 million	314,640	PLN 15.26%	EUR 11 1/4%	December 1, 2007
May 23, 2001	EUR 100 million	344,890	PLN 13.96%	EUR 10 7/8%	May 1, 2007
June 1, 2001	USD 75 million	298,837	PLN 14.79%	USD 11 1/4%	December 1, 2007
June 11, 2001	USD 125 million	496,438	PLN 13.52%	USD 10 3/4%	July 1, 2005
December 10, 2001	EUR 50 million	181,700	PLN 12.69%	EUR 10 7/8%	May 1, 2007
December 10, 2001	EUR 75 million	271,650	PLN 13.56%	EUR 11 1/4%	December 1, 2007

The timing of cash flows related to CC swaps is the same as for Notes interest obligation.

**24. Financial commitments****a. Operating leases (not included in liabilities)**

The minimum annual rentals payable on operating leases (both cancelable and non-cancelable) are as follows:

	<b>As at December 31, 2002</b>	<b>As at December 31, 2001</b>	<b>As at December 31, 2000</b>
	<b>(unaudited)</b>		
Not later than 1 year	112,563	118,654	101,280
Later than 1 year and not later than 5 years	354,935	361,141	303,480

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Later than 5 years	210,353	257,698	213,054
	<u>677,851</u>	<u>737,493</u>	<u>617,814</u>
Unlimited agreements (yearly)	20,884	22,610	19,443

Assets under operating leases include primarily network sites, office space, retail outlets and warehouses.

**b. Capital equipment commitments (not included in liabilities)**

	As at December 31, 2002	As at December 31, 2001	As at December 31, 2000
	(unaudited)		(restated)
Authorized and contracted	166,982	393,841	970,532
Authorized and not contracted	574,057	709,780	1,487,877
	<u>741,039</u>	<u>1,103,621</u>	<u>2,458,409</u>

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
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**25. Dividend restriction**

The Company's statutory financial statements are prepared in accordance with Polish accounting regulations. Dividends may only be distributed from the net profit reported in the unconsolidated Polish annual statutory financial statements.

As at the day of authorization of these consolidated financial statements the Company's Shareholders' Meeting has not made a decision of a distribution of profits.

Dividend distribution is restricted mainly by Notes Agreements that require the Company to have Debt to Adjusted Consolidated Net Worth ratio at the level below 2.0:1.0, which is not satisfying at the moment.

**26. Supplementary cash flow information**

Cash and cash equivalents consist of cash on hand, balances deposited with banks and short-term, highly liquid investments.

	As at December 31, 2002	As at December 31, 2001	As at December 31, 2000
	(unaudited)		(restated)
Balances deposited with banks:			
Current accounts	13,127	10,416	14,669
Term deposits with original maturity of less than 90 days	40,482	25,609	14,033
Social fund cash	620	301	602
Cash on hand	183	185	161
	<b>54,412</b>	<b>36,511</b>	<b>29,465</b>

As at December 31, 2002 the Company revalued cash on hand and balances deposited with banks denominated in foreign currencies. The net result of the revaluation was PLN 12 of foreign exchange losses, which were reported under interest and other financial expenses.

**Non-cash transactions**

	As at December 31, 2002	As at December 31, 2001	As at December 31, 2000
	(unaudited)		(restated)
UMTS license acquisition			1,279,147
Transfer of Shareholders' Loan to capital			392,927

**27. Employment**

	As at December 31, 2002	As at December 31, 2001	As at December 31, 2000
	(unaudited)		(restated)
Headcount at the year end	3,702	3,684	3,132

**28. Estimation of the fair values**

The following table presents the carrying amounts and fair values of the Company's financial instruments outstanding as at December 31, 2002 and 2001, in million PLN. The carrying amounts in the table are included in the balance sheet under the indicated captions.

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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**28. Estimation of the fair values (Continued)**

	As at December 31, 2002		As at December 31, 2001	
	million PLN (unaudited)		million PLN	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Cash and cash equivalents	54	54	37	37
Short-term investments and other financial assets	12	12	98	99
Debtors and accrued revenue	600	600	507	507
Financial assets (long-term)	171	171	106	106
<b>Financial Liabilities</b>				
Current liabilities and accruals	645	645	680	680
Long-term liabilities	4,531	4,758	5,055	5,073

***Debtors and accrued revenue, current liabilities and accruals***

The carrying amounts are a reasonable estimate of the fair values because of the short maturity of such instruments.

The carrying amounts of forward foreign exchange contracts are based on quoted market forward rates as at the year-end balance sheet dates.

***Cash and cash equivalents, short-term investments and financial assets (long-term)***

The carrying amounts of cash and cash equivalents approximate fair values. The fair value of publicly traded short-term investments is based on quoted market values.

***Long-term liabilities***

The fair value of fixed rate long-term debt is estimated using the expected future payments discounted at market interest rates, except for the publicly traded liabilities, which are quoted at market values. The carrying amount of market-based floating rate long-term loans approximates their fair value.

**29. Differences between IFRS and US GAAP**

The Company's consolidated financial statements are prepared in accordance with International Financial Reporting Standards, which differ in certain aspects from US GAAP.

The effects of the principal differences between IFRS and US GAAP in relation to the Company's consolidated financial statements are presented below, with explanations of certain adjustments that affect total comprehensive net income.



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**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**29. Differences between IFRS and US GAAP (Continued)**

Reconciliation of consolidated net income:

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Net income under IFRS	346,476	427,221	109,387
US GAAP adjustments:			
(a) Removal of foreign exchange differences capitalized for IFRS	(109,601)	107,075	4,176
(b) Depreciation and amortization of foreign exchange differences	9,528	9,268	9,188
(c) Revenue recognition (SAB 101)	(45)	1,151	(1,589)
(d) SFAS 133/IAS 39	(62,217)	(28,072)	
(f) Deferred tax on above	25,821	(8,367)	445
	<u>          </u>	<u>          </u>	<u>          </u>
Net income under US GAAP before cumulative effect on accounting changes	209,962	508,276	121,607
Accounting changes adjustments:			
(d) SFAS 133/IAS 39 implementation		(35,158)	
(e) Transaction costs		7,220	
(f) Deferred tax on above		6,470	
	<u>          </u>	<u>          </u>	<u>          </u>
Net income under US GAAP	<u><b>209,962</b></u>	<u><b>486,808</b></u>	<u><b>121,607</b></u>

Reconciliation of comprehensive income:

	Year ended December 31, 2002	Year ended December 31, 2001	Year ended December 31, 2000
	(unaudited)		(restated)
Net income under US GAAP	209,962	486,808	121,607
Other comprehensive gain/(loss) (Hedge Reserve)	4,408	(96,955)	
	<u>          </u>	<u>          </u>	<u>          </u>
Total comprehensive income under US GAAP	<u><b>214,370</b></u>	<u><b>389,853</b></u>	<u><b>121,607</b></u>

**Table of Contents****POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES****Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000**  
(in thousands of PLN)

**29. Differences between IFRS and US GAAP (Continued)**

Reconciliation of consolidated shareholders' equity:

	As at December 31, 2002	As at December 31, 2001	As at December 31, 2000
	(unaudited)		(restated)
Consolidated shareholders' equity under IFRS	1,352,527	995,745	686,947
US GAAP adjustments:			
(a) Removal of foreign exchange differences capitalized for IFRS	(101,590)	8,011	(99,064)
(b) Depreciation and amortization on above	41,761	32,233	22,965
(c) Revenue recognition (SAB 101)	(483)	(438)	(1,589)
(d) SFAS 133/IAS 39	(90,289)	(56,869)	
(f) Deferred tax on above	17,899	(1,299)	445
(h) Hedge reserve	(5,898)		
Consolidated shareholders' equity under US GAAP before cumulative effect on accounting changes	1,213,927	977,383	609,704
Accounting changes adjustments:			
(d) SFAS 133/IAS 39 implementation		28,797	
(e) Deferred tax on above		(6,623)	
Consolidated shareholders' equity under US GAAP	<b>1,213,927</b>	<b>999,557</b>	<b>609,704</b>

**a. Removal of foreign exchange differences capitalized for IFRS**

In accordance with IAS 23 *Borrowing Costs*, the Company capitalizes financing costs, including interest and foreign exchange gains or losses, into assets under construction.

For property, plant and equipment under construction, the Company capitalizes interest and foreign exchange gains or losses incurred and directly attributable to the acquisition and construction of the qualifying assets that would have been avoided if the expenditure on the qualifying assets had not been made. The financing costs are capitalized only during the period of construction of the qualifying assets (see Note 14). The Company capitalized financing costs attributable to the acquisition of its GSM 900, GSM 1800 and UMTS licenses, including interest on the related long-term obligation and foreign exchange losses because these licenses are integral parts of the network (see Note 15).

Under Statement of Financial Accounting Standards 52 *Foreign Currency Translation*, however, foreign exchange differences relating to financing obligations should be included in the income statement of the Company. Consequently, the amounts of foreign exchange differences capitalized in accordance with IAS 23 in the Company's consolidated financial statements are expensed under US GAAP.

**b. Depreciation and amortization**

The US GAAP adjustments for depreciation and amortization shown above represent the amounts of depreciation and amortization charges relating to capitalized foreign exchange differences in the Company's IFRS consolidated financial statements. Since under US GAAP these foreign exchange differences are not permitted to be capitalized and are instead expensed, the depreciation and amortization of these capitalized differences under IFRS has been reversed.

**c. Revenue recognition (SAB 101)**

As described in Note 3.1 the Company applied under IFRS certain principles of SAB 101 retrospectively.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**29. Differences between IFRS and US GAAP (Continued)**

**c. Revenue recognition (SAB 101) (Continued)**

Under US GAAP, the application of SAB 101 results in the different treatment of the *separable* multiple-element transactions. Revenues and costs related to those transactions are recognized in the income statement as incurred, except for up-front non-refundable fees (activation fees) and direct costs related to these fees. These activation fees and related costs are deferred over the average expected life of the customer. Under IFRS up-front non-refundable fees are recognized immediately.

**d. SFAS 133**

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires every derivative instrument (including certain derivative instruments embedded in other contracts) to be recorded in the balance sheet as either an asset or liability measured at its fair value. The Statement requires that changes in the derivative instrument's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the income statement, to the extent effective, and requires that a company must formally document, designate, and assess the effectiveness of transactions that receive hedge accounting.

The Company separates call options from long-term Notes' host contract and accounts for as derivatives under IAS 39, while they are not recognized for US GAAP purposes.

The accounting change principles under US GAAP advise to include the cumulative effect in the net income of the period of the change. However, for qualifying cash flow hedge instruments portion (or the entirety) of the cumulative effect should be classified in the other comprehensive income (hedge reserve), a component of shareholders' equity.

**e. Transaction costs**

IAS 39 requires transaction costs to be included in the initial measurement of financial assets and liabilities. Under US GAAP these costs should be presented as deferred costs in the amount of PLN 73,642 as at January 1, 2001, PLN 83,645 as at December 31, 2001 and PLN 71,258 as at December 31, 2002.

**f. Deferred taxation**

Under IFRS the Company may, if certain criteria are met, net deferred tax liabilities and assets and present a net balance in the balance sheet. Under US GAAP current and non-current portions, by tax jurisdiction, of the above should be disclosed separately. As at December 31, 2002 the Company recognized PLN 234,320 of net current deferred tax asset (PLN 210,978 as at December 31, 2001 and PLN 47,574 as at December 31, 2000) and PLN 484,592 of net long-term deferred tax liability (PLN 271,021 as at December 31, 2001 and PLN 107,637 as at December 31, 2000).

Under IFRS changes in fair value of Note options are not taxable transactions, which causes the effective tax rate on US GAAP adjustments different compared to corporate income tax rates for the periods.

**g. Extraordinary item**

In the first quarter of 2001 the Company refinanced the existing Loan Facility by the new Bank Credit Facilities. The intangible asset related to the Loan facility arrangement amounting to PLN 10,122 was written-off, net of a tax benefit of PLN 2,834. According to U.S. GAAP the Company should recognize this costs as an extraordinary item. Under IFRS it is presented under amortization expense.

**h. Other comprehensive income**

The hedge reserve under US GAAP constitutes a part of other comprehensive income, a component of shareholders' equity. The changes in other comprehensive income (hedge reserve) are reflected in

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**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**for the years ended December 31, 2002, December 31, 2001 and December 31, 2000  
(in thousands of PLN)**

**29. Differences between IFRS and US GAAP (Continued)**

**h. Other comprehensive income (Continued)**

accumulated other comprehensive income. A sum of other comprehensive income and net income for the period represents comprehensive income for the period.

**i. SFAS 95**

The Company applied IAS 7 *Cash Flow Statement* so that cash flow from operating activities begins with net income before taxation, whereas Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows* requires cash flow from operating activities to begin with net income after tax.

**j. New accounting standards**

The implementation of the Statements No. 141, *Business Combinations*, No. 142, *Goodwill and Other Intangible Assets* and No. 144, *Accounting for the Impairment of Long Lived Assets* from January 1, 2002 has not caused material changes to the Company's consolidated financial statements.

The Company plans to implement Statements No. 143, *Accounting for Asset Retirement Obligations* (effective for fiscal years beginning after June 15, 2002), No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (effective for fiscal years beginning after May 15, 2002), No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (effective for exit and disposal activities initiated after December 31, 2002) and EITF 00-21 *Accounting for Revenue Arrangements with Multiple Deliverables* from January 1, 2003.

The Company has finished preparation for SFAS 143 introduction and assesses the impact of this new standard as immaterial to its financial statements. As at the time of authorization of the underlying financial statements potential effects of the introduction of EITF 00-21 has been under the Company's investigation.



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**VIRGIN MOBILE TELECOMS LIMITED**

**Report and Financial Statements**

**31 December 2002**

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**VIRGIN MOBILE TELECOMS LIMITED**

**REPORT AND FINANCIAL STATEMENTS 2002**

(ACCORDING TO U.K. GAAP)

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**VIRGIN MOBILE TELECOMS LIMITED**

**CHAIRMAN'S STATEMENT**

I am delighted to be able to report a third successful full year of trading for Virgin Mobile. The business continued to thrive and prosper, to grow rapidly, and ended the year in profit. This is a remarkable achievement, and I should like to offer my congratulations to the management team and staff.

Virgin Mobile outperformed the targets of its business plan by some margin during the year. Its results and performance in respect of the financial year ended 31 December 2002 were, I am pleased to report, comfortably ahead of forecasts.

The numbers of customers attracted to Virgin Mobile continued to be high. The company consolidated its position as a credible alternative to the traditional networks, so much so that over the course of the year Virgin Mobile attracted more net new customers than rivals: Orange, O2 and Vodafone.

We passed several milestones, in particular, attracting our two millionth customer, in 2002. The fourth quarter of the year was our best-ever sales period, during which time we attracted 370,530 net new customers. This strong sales performance was against intense competition in the mobile sector.

Despite our aggressive rate of growth, operational costs remained tightly managed. And with greater economies of scale across the company and increasing revenues, 2002 was a year of profitable growth. Virgin Mobile achieved revenues of £288 million, EBITDA of £16.1 million and an operating profit of £4.8 million. As a consequence, we began repaying our bank facility ahead of schedule.

This robust financial performance was a reflection of consumers' increasingly favourable sentiment to the Virgin Mobile brand, proposition and service. As testament to this, Virgin Mobile again collected several major industry awards, most notably, for the second year running, the Best Pre-Pay Package and the Best Customer Service Awards from Mobile Choice magazine, and the Best Retail and Consumer Services Award from Management Today magazine. The excellence of our human resources and training teams also contributed to Virgin Mobile winning the Best Customer Centre Induction Training Award at the annual European Call Centre Awards.

On the High Street, Virgin Mobile continued its expansion into new stores, such as specialists Phones 4 U and TOMO, and into more generalist retailers such as Comet and Woolworths. Elsewhere, we bolstered our existing presence in stores such as Carphone Warehouse and Tesco, where Virgin Mobile was regularly among the top sellers.

We maintain a strong relationship with Virgin Retail Group, which again provided a significant contribution, 22%, to Virgin Mobile's sales. During the year some of Virgin's V.SHOP estate was sold to Sanity, which continued to successfully retail Virgin Mobile. The other V.SHOP stores began a rebranding programme to a new retail format, Virgin Megastore Xpress.

Virgin Mobile pursued its tradition of innovation with the introduction of several new services and a range of leading-edge colour-screen phones into its product portfolio during the year.

The business was a keen participant in the industry-wide mobile phone recycling initiative, Fonebak. For every Virgin Mobile phone that is recycled under the scheme, the company makes a donation of £5 to The British Red Cross. Virgin Mobile was also an active supporter of other charities, and of the government and industry campaigns to reduce the incidence of mobile phone-related crime.

Unfortunately, towards the end of the year, disagreements between the shareholders and between T-Mobile and Virgin Mobile were escalated to the High Court in two separate cases. The prospect of further legal action remains for 2003. I am thankful for the ongoing support of our banks and employees during this time.



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With the continuing support of our customers, suppliers, and through the dedication of our people, I believe Virgin Mobile will enjoy a successful 2003 and beyond.

**Harris Jones**

**Chairman**

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**VIRGIN MOBILE TELECOMS LIMITED**

**DIRECTORS REPORT**

The directors present their annual report and the audited financial statements for the year ended 31 December 2002.

**PRINCIPAL ACTIVITIES**

The principal activities of the group comprise of the sale of mobile phone handsets (both direct to end customers and to retailers) and the provision of mobile telecommunication services.

**BUSINESS REVIEW AND RESULTS**

The turnover and profit for the financial year were £287,720,000 (2001 £173,860,000) and £1,996,000 (2001 loss of £58,939,000) respectively. Details of the group's financial position as at 31 December 2002 is given in the group's Consolidated Balance Sheet.

No equity dividends were paid or proposed. A preference dividend of £9,011 (2001 £9,011) per share totalling £2,703,300 (2001 £2,703,300) has been calculated on the issue price of the 300 cumulative redeemable preference shares at the rate of 9% per annum. Interest on late payment of cumulative dividends of £1,234,700 (2001 £893,700) is calculated at 11% above the Natwest lending rate and is included in the finance costs of non-equity shares. An indication of future developments of the business is given in the Chairman's Statement.

**DIRECTORS**

The directors who served during the year were as follows:

Sir Richard C.N. Branson  
Julia S. Chain  
Harris Jones (Chairman)  
Gordon D. McCallum  
Andrew R. Peters  
Alan D. Robbins (alternate director to Gordon McCallum, revoked 15 February 2002)  
Robert W. Samuelson  
William E. Whitehorn (alternate director to Richard Branson)

Details of directors' share interests are given in Note 6 to the accounts.

**SUPPLIER PAYMENT POLICY**

The company's policy, which is also applied by the group, is to settle terms of payment with suppliers when agreeing the terms of each transaction, ensure that suppliers are made aware of the terms of payment and abide by the terms of payment.

**EMPLOYEE CONSULTATION**

The group places considerable value on the involvement of its employees and has continued to keep them informed on matters affecting them as employees and on the various factors affecting the performance of the group. Employee representatives are consulted regularly on a wide range of matters affecting current and future interests.

**DISABLED EMPLOYEES**

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Applications for employment by disabled persons are always fully considered, bearing in mind the aptitudes of the applicant concerned. In the event of members of staff becoming disabled every effort is made to ensure that their employment with the company continues and that appropriate training is arranged. It is the policy of the company that the training, career development and promotion of disabled persons should, as far as possible, be identical with that of other employees.

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AUDITORS

During the year Arthur Andersen resigned as auditors. Deloitte & Touche were appointed to fill the casual vacancy. The members of the Company have passed elective resolutions in accordance with Sections 366A, 252 and 386 of the Companies Act 1985 dispensing with the previous statutory requirements of holding annual general meetings, laying accounts before the company in general meetings and re-appointing auditors annually.

Approved by the Board of Directors

and signed on behalf of the Board

Peter Gram

Company Secretary

120 Campden Hill Road

London  
W8 7AR  
England

16 April 2003

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**VIRGIN MOBILE TELECOMS LIMITED**

**STATEMENT OF DIRECTORS RESPONSIBILITIES**

United Kingdom company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company as at the end of the financial year and of the profit or loss of the company for that period. In preparing those financial statements, the directors are required to:

select suitable accounting policies and then apply them consistently;

make judgements and estimates that are reasonable and prudent;

state whether applicable accounting standards have been followed;

prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for the system of internal control, safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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Table of Contents**VIRGIN MOBILE TELECOMS LIMITED****CONSOLIDATED PROFIT AND LOSS ACCOUNT (UNAUDITED)**

According to U.K. GAAP  
Year ended 31 December 2002

	Note	2002	2001
		£ 000	£ 000
<b>TURNOVER</b>	2	287,720	173,860
Cost of sales		(175,682)	(127,771)
<b>GROSS PROFIT</b>		112,038	46,089
Administrative expenses		(107,202)	(93,794)
<b>OPERATING PROFIT (LOSS)</b>		4,836	(47,705)
Finance charges (net)	3	(11,841)	(11,234)
<b>LOSS ON ORDINARY ACTIVITIES BEFORE TAXATION</b>	4	(7,005)	(58,939)
Tax on loss on ordinary activities	7	9,001	
<b>PROFIT (LOSS) FOR THE FINANCIAL YEAR</b>		1,996	(58,939)
Finance costs of non-equity shares		(3,938)	(3,597)
<b>Retained loss for the year</b>		(1,942)	(62,536)

All amounts derive from continuing operations.

There were no other recognised gains and losses in either year.

The accompanying notes are an integral part of this consolidated profit and loss account.

**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****CONSOLIDATED BALANCE SHEET (UNAUDITED)**

According to U.K. GAAP  
31 December 2002

	Note	2002	2001
		£ 000	£ 000
<b>FIXED ASSETS</b>			
Tangible assets	9	24,828	16,798
<b>CURRENT ASSETS</b>			
Stocks	11	5,671	4,927
Debtors	12	52,706	33,749
Cash at bank and in hand		13,110	9,714
		71,487	48,390
<b>CREDITORS: amounts falling due within one year</b>	13	(112,924)	(60,699)
<b>NET CURRENT LIABILITIES</b>			
		(41,437)	(12,309)
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>			
		(16,609)	4,489
<b>CREDITORS: amounts falling due after more than one year</b>	14	(143,144)	(166,238)
<b>NET LIABILITIES</b>			
		(159,753)	(161,749)
<b>CAPITAL AND RESERVES</b>			
Called up share capital	16	19	19
Share premium account	17	30,036	30,036
Profit and loss account	17	(189,808)	(191,804)
<b>ACCUMULATED DEFICIT</b>			
	18	(159,753)	(161,749)
Accumulated deficit may be analysed as:			
Equity interests		(200,865)	(198,923)
Non-equity interests		41,112	37,174
		(159,753)	(161,749)

These financial statements were approved by the Board of Directors on 16 April 2003 and signed on its behalf by:

Director

16 April 2003

The accompanying notes are an integral part of this consolidated balance sheet.

**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****COMPANY BALANCE SHEET (UNAUDITED)**

According to U.K. GAAP  
31 December 2002

	Note	2002	2001
		£ 000	£ 000
<b>FIXED ASSETS</b>			
Tangible assets	9	23,735	13,387
Investments	10		
		23,735	13,387
<b>CURRENT ASSETS</b>			
Stocks	11	5,671	4,927
Debtors	12	58,251	40,017
Cash at bank and in hand		13,109	9,713
		77,031	54,657
<b>CREDITORS: amounts falling due within one year</b>	13	(112,778)	(60,480)
<b>NET CURRENT LIABILITIES</b>			
		(35,747)	(5,823)
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>			
		(12,012)	7,564
<b>CREDITORS: amounts falling due after more than one year</b>	14	(141,729)	(164,613)
<b>NET LIABILITIES</b>			
		(153,741)	(157,049)
<b>CAPITAL AND RESERVES</b>			
Called up share capital	16	19	19
Share premium account	17	30,036	30,036
Profit and loss account	17	(183,796)	(187,104)
<b>ACCUMULATED DEFICIT</b>			
		(153,741)	(157,049)
Accumulated deficit may be analysed as:			
Equity interests		(194,853)	(194,223)
Non-equity interests		41,112	37,174
		(153,741)	(157,049)

These financial statements were approved by the Board of Directors on 16 April 2003 and signed on its behalf by:

Director

16 April 2003

The accompanying notes are an integral part of this balance sheet.



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## VIRGIN MOBILE TELECOMS LIMITED

## CONSOLIDATED CASH FLOW STATEMENT (UNAUDITED)

According to U.K. GAAP  
Year ended 31 December 2002

	Note	2002	2001
		£ 000	£ 000
<b>Net cash inflow (outflow) from operating activities</b>	19	34,712	(54,065)
Returns on investments and servicing of finance	20	(7,746)	(4,208)
Capital expenditure and financial investment	20	(18,315)	(8,836)
		<u>          </u>	<u>          </u>
<b>Cash inflow (outflow) before financing</b>		8,651	(67,109)
Financing	20	(5,255)	74,858
		<u>          </u>	<u>          </u>
<b>Increase in cash in the year</b>	21	<u>3,396</u>	<u>7,749</u>

The accompanying notes are an integral part of this consolidated cash flow statement.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited)**

**Year ended 31 December 2002**

**1. ACCOUNTING POLICIES**

The financial statements are prepared in accordance with applicable accounting standards. The particular accounting policies adopted are described below.

**Accounting convention**

The financial statements are prepared under the historical cost convention.

Financial Reporting Standard 19 Deferred Tax (FRS 19) has been adopted for the first time by the group in the year ended 31 December 2002. In previous years the group complied with Statement of Standard Accounting Practice 15 Deferred Tax (SSAP 15) which has now been superseded by the introduction of FRS 19. SSAP 15 required a provision to be made using the liability method to the extent that net deferred assets or liabilities were likely to crystallise in the foreseeable future. This method was commonly referred to as partial provisioning. FRS 19, by contrast, requires a form of full provisioning (see deferred tax accounting policy note). There has been no effect of the implementation of FRS 19 on previously reported results.

**Basis of preparation and future funding**

As at 31 December 2002 the group had net liabilities of £159,753,000 (2001 £161,749,000). The group is currently being financed by a syndicated bank loan (see note 15) and by its shareholders, T-Mobile and the Virgin Group (see note 25). The group had drawn down £100,000,000 under the £115,000,000 syndicated bank loan as at 31 December 2001. During 2002, the group did not draw down any further amounts and had repaid £5,000,000 of the loan by the year end. While there can be no certainty about the group's future operating performance, based on the group's five year business plan, approved on 22 March 2002 and which remains in force, and recent trading performance, the directors expect that the group will generate cash during the next twelve months so that scheduled loan repayments will be met and that the group will comply with the syndicated bank loan covenants. The shareholder loans are not repayable until the syndicated bank loan has been repaid in full. The directors do not believe any current legal dispute between the shareholders will have a material impact on the group's future funding (see note 26). Therefore, the directors have prepared these accounts on a going concern basis.

**Basis of consolidation**

The group accounts consolidate the accounts of Virgin Mobile Telecoms Limited and its subsidiary undertaking drawn up to 31 December each year. The results of subsidiaries acquired are consolidated for the periods from which control passed. Acquisitions are accounted for under the acquisition method.

**Turnover**

Turnover represents amounts receivable for handset and airtime services provided in the normal course of business, net of VAT and trade discounts.

Handsets, and other equipment, revenue is recognised based on the amounts received at the date of sale. Airtime turnover derived from customers is recognised based on the usage of the network in the period. Prepaid airtime sales are deferred until the customer uses the stored value.

**Subscriber acquisition costs**



Subscriber acquisition costs, which include the commission costs associated with acquiring new customers and other incremental costs of customer acquisition, are recognised in the profit and loss account as incurred.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****Tangible fixed assets**

Tangible fixed assets are stated at cost, net of depreciation and any provision for impairment. Depreciation is provided on all tangible fixed assets at rates calculated to write off the cost or valuation, less estimated residual value, of each asset on a straight-line basis over its expected useful life, as follows:

Leasehold improvements	3 years
Computer systems	2-3 years
Fixtures and fittings	3 years
Office equipment	3 years

Residual value is calculated on prices prevailing at the date of acquisition. Depreciation is not charged on assets in the course of construction until they are ready for service.

**Web site development costs**

Design and content development costs are capitalised only to the extent that they lead to the creation of an enduring asset delivering benefits at least as great as the amount capitalised. If there is insufficient evidence on which to base reasonable estimates of the economic benefits that will be generated in the period until the design and content are next updated, the costs of developing the design and content are charged to the profit and loss account as incurred.

**Investments**

Fixed asset investments are shown at cost less provision for impairment. Current asset investments are stated at the lower of cost and net realisable value.

**Stocks**

Stocks are stated at the lower of cost and net realisable value. Net realisable value is based on estimated selling price, less further direct selling costs. Provision is made for obsolete, slow-moving or defective items where appropriate.

**Pension costs**

For defined contribution schemes the amount charged to the profit and loss account in respect of pension costs and other post-retirement benefits is the contributions payable in the year. Differences between contributions payable in the year and contributions actually paid are shown as either accruals or prepayments in the balance sheet.

**Taxation**

Corporation tax is provided on taxable profits at the current rate.

Deferred tax is provided in full on all timing differences which result in an obligation at the balance sheet date to pay more tax, or a right to pay less tax, at a future date, at rates expected to apply when they crystallise based on current tax rates and laws. Timing differences arise from the inclusion of items of income and

expenditure in taxation computations in periods different from those in which they are included in the financial statements. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

**Leases**

Assets obtained under hire purchase contracts or finance leases are capitalised in the balance sheet. Those held under hire purchase contracts are depreciated over their useful economic lives. Those held under finance leases are depreciated over their estimated useful lives or the leases term, whichever is shorter.

The interest element of these obligations is charged to the profit and loss account over the relevant period. The capital element of the future payments is treated as a liability.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) (Continued)**

**Year ended 31 December 2002**

Rentals under operating leases are charged on a straight-line basis over the lease term, even if the payments are not made on such a basis. Benefits received and receivable as an incentive to sign an operating lease are similarly spread on a straight-line basis over the lease term, except where the period to the review date on which the rent is first expected to be adjusted to the prevailing market rate is shorter than the full lease term, in which case the shorter period is used.

**Finance costs**

Finance costs of debt and non-equity shares are recognised in the profit and loss account over the term of such instruments at a constant rate on the carrying amount. Where the finance costs for non-equity shares are not equal to the dividends on these instruments, the difference is also accounted for in the profit and loss account as an appropriation of profits.

**Debt**

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. The carrying amount is increased by the finance cost in respect of the accounting period and reduced by payments made in the period. Convertible debt is reported as a liability unless conversion actually occurs. No gain or loss is recognised on conversion.

**Foreign currency**

Transactions in foreign currencies are recorded at the rate of exchange at the date of the transaction or, if hedged, at the forward contract rate. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are reported at the rates of exchange prevailing at that date or, if appropriate, at the forward contract rate.

**Derivative financial instruments**

The group uses derivative financial instruments to reduce exposure to interest rate movements and foreign exchange risk. The group does not hold or issue derivative financial instruments for speculative purposes.

For an interest rate swap to be treated as a hedge the instrument must be related to actual assets or liabilities or a probable commitment and must change the nature of the interest rate by converting a fixed rate to a variable rate or vice versa. Interest differentials under these swaps are recognised by adjusting net interest payable over the periods of the contracts.

For a forward contract to be treated as a hedge the instrument must be related to actual foreign currency assets or liabilities or to a probable commitment. It must involve the same currencies or similar currencies as the hedged item and must also reduce the risk of foreign exchange movements on the group's operations. Gains and losses arising on these contracts are only recognised in the profit and loss account when the hedged transaction itself has been reflected in the group's accounts.

If an instrument ceases to be accounted for as a hedge, for example because the underlying hedged position is eliminated, the instrument is marked to market and any resulting profit or loss recognised at that time.

**2. SEGMENTAL INFORMATION**

The group's operations and markets are located within the United Kingdom and form a single class of business.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****3. FINANCE CHARGES (NET)**

	<b>2002</b>	<b>2001</b>
	<b>£ 000</b>	<b>£ 000</b>
Bank loans and overdrafts	(6,944)	(6,004)
Finance lease interest	(57)	(58)
Interest payable to related companies	(5,362)	(5,655)
Interest receivable and similar income	522	483
	<b>(11,841)</b>	<b>(11,234)</b>

**4. LOSS ON ORDINARY ACTIVITIES BEFORE TAXATION**

Loss on ordinary activities before taxation is stated after charging:

	<b>2002</b>	<b>2001</b>
	<b>£ 000</b>	<b>£ 000</b>
Depreciation and amounts written off tangible fixed assets		
Owned assets	11,071	11,930
Leased assets	215	108
Operating lease rentals		
Leasehold property	1,179	1,120
Auditors' remuneration for audit services	151	142

Amounts payable to the auditors by the company and its subsidiary undertaking in respect of non-audit services were £491,438 (2001 £136,324).

**5. STAFF COSTS**

The average monthly number of employees (including executive directors) was:

	<b>2002</b>	<b>2001</b>
	<b>No.</b>	<b>No.</b>
Distribution	43	48
Marketing	45	32
Administration	1,039	892
	<b>1,127</b>	<b>972</b>

Their aggregate remuneration comprised:

	£ 000	£ 000
	<u>          </u>	<u>          </u>
Wages and salaries	27,921	18,660
Social security costs	2,432	1,648
Other pension costs (see note 23)	776	549
	<u>          </u>	<u>          </u>
	31,129	20,857
	<u>          </u>	<u>          </u>

## 6. DIRECTORS REMUNERATION, INTERESTS AND TRANSACTIONS

### *Aggregate remuneration*

Virgin Management Limited and T-Mobile each provide three directors of the company and receive a £45,000 (2001 £45,000) consultancy fee for these executive services. The total amount of directors remuneration and other benefits were £90,000 (2001 £90,000).

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****Directors' interests**

Sir Richard Branson is deemed to have an interest in the share capital of the company by virtue of being one of the principal beneficiaries of a number of trusts that own Virgin Group Investments Limited, the ultimate parent company of Bluebottle Investments Inc., Bluebottle Investments S.A. and Bluebottle UK Limited, which hold shares in the capital of the company.

Gordon D. McCallum is deemed to have an interest in the share capital of the company by virtue of being one of the beneficiaries of a trust that holds shares in the capital of the company.

**7. TAX ON LOSS ON ORDINARY ACTIVITIES**

The tax credit comprises:

	<u>2002</u>	<u>2001</u>
	<u>£ 000</u>	<u>£ 000</u>
<b>Current tax</b>		
UK corporation tax	—	—
<b>Total current tax</b>		
<b>Deferred tax</b>		
Origination and reversal of timing differences (see note 12)	9,001	—
<b>Total deferred tax asset</b>	9,001	—
<b>Total tax credit on loss on ordinary activities</b>	<b>9,001</b>	<b>—</b>

The differences between the total current tax shown above and the amount calculated by applying the standard rate of UK corporation tax to the loss before tax is as follows:

	<u>2002</u>	<u>2001</u>
	<u>£ 000</u>	<u>£ 000</u>
Loss on ordinary activities before tax	(7,005)	(58,939)
Tax on loss on ordinary activities at standard UK corporation tax rate of 30% (2001 30%)		
Effects of:		
Expenses not deductible for tax purposes	158	111
Depreciation in excess of capital allowances	3,346	3,611
Current year tax losses	(3,504)	(3,722)





**8. LOSS ATTRIBUTABLE TO VIRGIN MOBILE TELECOMS LIMITED**

The loss for the financial period dealt with in the accounts of the company, Virgin Mobile Telecoms Limited, was £630,000 (2001 loss of £56,803,000). As permitted by Section 230 of the Companies Act 1985, no separate profit and loss account is presented in respect of the company.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****9. TANGIBLE FIXED ASSETS**

Group	Leasehold improvements	Fixtures and fittings	Office equipment	Computer systems	Total
	£ 000	£ 000	£ 000	£ 000	£ 000
<b>Cost</b>					
At 1 January 2002	7,792	662	273	29,116	37,843
Additions	3	42	26	19,245	19,316
At 31 December 2002	7,795	704	299	48,361	57,159
<b>Accumulated depreciation</b>					
At 1 January 2002	4,108	476	179	16,282	21,045
Charge for the year	2,470	175	83	8,558	11,286
At 31 December 2002	6,578	651	262	24,840	32,331
<b>Net book value</b>					
At 31 December 2002	1,217	53	37	23,521	24,828
At 31 December 2001	3,684	186	94	12,834	16,798

Company	Leasehold improvements	Fixtures and fittings	Office equipment	Computer systems	Total
	£ 000	£ 000	£ 000	£ 000	£ 000
<b>Cost</b>					
At 1 January 2002	447	662	273	29,116	30,498
Additions		42	26	19,245	19,313
At 31 December 2002	447	704	299	48,361	49,811
<b>Accumulated depreciation</b>					
At 1 January 2002	174	476	179	16,282	17,111
Charge for the year	149	175	83	8,558	8,965
At 31 December 2002	323	651	262	24,840	26,076
<b>Net book value</b>					
At 31 December 2002	124	53	37	23,521	23,735
At 31 December 2001	273	186	94	12,834	13,387

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Tangible fixed assets include computer equipment at a cost of £644,375 (2001 £644,375) and net book value of £321,922 (2001 £536,537) in respect of assets held under a finance lease.

Computer systems for the group and company includes £15,314,000 (2001 £2,108,000) of assets in the course of construction.

### 10. FIXED ASSET INVESTMENTS

#### *Subsidiary undertaking*

Virgin Mobile Telecoms Limited has a £2 investment representing a 100% holding in Bluebottle Call Limited, a subsidiary undertaking, the principal business of which is property investment. Bluebottle Call Limited is incorporated in England and Wales.

### 11. STOCKS

	Group		Company	
	2002	2001	2002	2001
	£ 000	£ 000	£ 000	£ 000
Finished goods held for resale	5,671	4,927	5,671	4,927

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****12. DEBTORS**

	<b>Group</b>		<b>Company</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
Trade debtors	27,542	17,189	27,542	17,189
Amounts owed by other related companies (see note 25)	13,019	13,271	13,019	13,271
Amounts owed by subsidiary undertaking			6,689	7,305
Deferred tax asset	9,001		8,852	
Other debtors		516		493
Prepayments and accrued income	3,144	2,773	2,149	1,759
	<b>52,706</b>	<b>33,749</b>	<b>58,251</b>	<b>40,017</b>

A deferred tax asset of £9,001,000 has been recognised at 31 December 2002 (2001 £nil). Detailed group budgets indicate that taxable profits will arise in the future. Based on these budgets the directors consider that a deferred tax asset of £9,001,000 should be recognised. A deferred tax asset of £49,908,000 has not been recognised in respect of certain tax losses and tax allowances as there remains a high enough degree of uncertainty regarding the future for these assets not to be regarded as more likely than not to reverse.

**13. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR**

	<b>Group</b>		<b>Company</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
Bank loans	23,000		23,000	
Obligations under finance lease contract	233	255	233	255
Trade creditors	21,203	21,664	21,203	21,664
Amounts owed to other related companies (see note 25)	1,842	2,874	1,842	2,874
Other taxation and social security	5,415	686	5,478	686
Other creditors	392	1,669	392	1,669
Accruals and deferred income	60,839	33,551	60,630	33,332
	<b>112,924</b>	<b>60,699</b>	<b>112,778</b>	<b>60,480</b>

**14. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR**

<b>Group</b>	<b>Company</b>
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	2002	2001	2002	2001
	£ 000	£ 000	£ 000	£ 000
Obligations under finance lease contract		233		233
Bank loans	72,000	100,000	72,000	100,000
Amounts owed to other related companies (see note 25)	69,676	64,314	69,676	64,314
Accruals and deferred income	1,468	1,691	53	66
	<u>143,144</u>	<u>166,238</u>	<u>141,729</u>	<u>164,613</u>

During the year ending 31 December 2002 the company has repaid £5 million of the syndicated loan facility. The loan facility is secured on the share capital and assets of the group.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002*****Finance Leases***

The net finance lease obligations to which the group and company are committed and which are secured on the related assets are:

	<b>Group and Company</b>	
	<b>2002</b>	<b>2001</b>
	<b>£ 000</b>	<b>£ 000</b>
In one year or less	233	255
Between one and two years	—	233
	233	488

**15. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS**

Set out below is an explanation of the role financial instruments have had during the period in creating or changing the risks the group faces in its activities. The explanation summarises the objectives and policies for holding or issuing financial instruments and similar contracts, and the strategies for achieving those objectives that have been followed during the period.

The company has established treasury policies that are reviewed annually by the Board or Audit committee to ensure they remain relevant to rapid business change.

The major financial risks faced by the group are exchange rate, interest rate exposure and liquidity risk. These are outlined below:

***Foreign currency risk***

About one-third of the handset purchases made by the company are from suppliers in continental Europe. These purchases are invoiced in Euros. The company's policy is to eliminate some currency exposure on purchases at the time of purchase through forward currency contracts. All other purchases are denominated in sterling.

***Interest rate risk***

The company has entered into interest rate swaps to hedge against adverse movements in LIBOR in relation to its syndicated loan facility. The company's policy is to keep between 50 per cent and 75 percent of the syndicated loan borrowing at fixed rates of interest. At the year-end, 79 per cent of the syndicated loan was at fixed rates after taking account of interest rate swaps following the repayment of £5 million of the syndicated loan facility.

The numerical disclosures in this note deal with financial assets and financial liabilities as defined in Financial Reporting Standard 13 Derivatives and other financial instruments: Disclosures (FRS 13). For this purpose non-equity shares issued by the company are dealt with in the disclosures in the same way as the group's

financial liabilities but separately disclosed. Certain financial assets such as investments in subsidiary and associated companies are also excluded from the scope of these disclosures.

As permitted by FRS 13, short term debtors and creditors have been excluded from the disclosures, other than the currency disclosures.

***Liquidity risk***

The company's overall objective is to ensure that it is, at all times, able to meet its financial commitments as and when they fall due. To this end, surplus funds are collected and invested with approved counterparties, within authorised limits, with the aim of maintaining short term liquidity while maximising yield.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****Interest rate profile**

The group has no financial assets other than cash at bank.

After taking into account interest rate swaps, the interest rate profile of the group's financial liabilities at 31 December 2002 was as follows:

	2002		
	Total	Floating rate	Fixed rate
	£ 000	£ 000	£ 000
<b>Currency</b>			
Sterling			
Borrowings	164,909	89,676	75,233
Non-equity shares	30,050		30,050
<b>Total</b>	<b>194,959</b>	<b>89,676</b>	<b>105,283</b>

The profile at 31 December 2001 for comparison purposes was as follows:

	2001		
	Total	Floating rate	Fixed rate
	£ 000	£ 000	£ 000
<b>Currency</b>			
Sterling			
Borrowings	164,802	89,314	75,488
Non-equity shares	30,050		30,050
<b>Total</b>	<b>194,852</b>	<b>89,314</b>	<b>105,538</b>

Further analysis of the interest rate profile at 31 December 2002 and at 31 December 2001 is as follows:

	2002	
	Fixed rate	
	Weighted average interest rate (%)	Weighted average period for which rate is fixed Years



Currency		
Sterling		
Borrowings	7.4	1.0

**2001  
Fixed rate**

Currency	Weighted average interest rate (%)	Weighted average period for which rate is fixed Years
Sterling		
Borrowings	7.4	2.6

Cumulative redeemable preference share dividends accrue on the non-equity shares at the rate of 9% per annum. Dividend interest on late payment is charged at 11% above the Natwest lending rate. As there is no defined maturity date, the non-equity shares have been excluded from the weighted average analysis.

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The interest rate on floating rate shareholder loans is at 4% above the three-month LIBOR rate. The interest rate on the floating rate element of the facility loan is linked to the LIBOR for a comparable period to that of the remaining term of the facility.

***Currency exposures***

As at 31 December 2002, after taking into account the effects of forward foreign exchange contracts the company had no currency exposures (2001 £nil).

***Maturity of financial liabilities***

The maturity profile of the group's financial liabilities at 31 December 2002 was as follows:

	<b>Non-equity shares</b>	<b>Borrowings</b>	<b>Total</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
In one year or less		23,233	23,233
In more than one year but not more than two years		46,000	46,000
In more than two years but not more than five years		95,676	95,676
In more than five years	30,050		30,050
<b>Total</b>	<b>30,050</b>	<b>164,909</b>	<b>194,959</b>

The profile at 31 December 2001 for comparison purposes was as follows:

	<b>Non-equity shares</b>	<b>Borrowings</b>	<b>Total</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
In one year or less		255	255
In more than one year but not more than two years		23,233	23,233
In more than two years but not more than five years		141,314	141,314
In more than five years	30,050		30,050
<b>Total</b>	<b>30,050</b>	<b>164,802</b>	<b>194,852</b>

***Borrowing facilities***

The group had undrawn committed borrowing facilities at 31 December 2002 and 31 December 2001 in respect of which all conditions precedent had been met, as follows:

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	<u>2002</u>	<u>2001</u>
	<u>£ 000</u>	<u>£ 000</u>
Expiring in one year or less		
Expiring in more than one year but not more than two years		
Expiring in more than two years	15,000	15,000
	<u>          </u>	<u>          </u>
Total	15,000	15,000
	<u>          </u>	<u>          </u>

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002*****Fair values***

Set out below is a comparison by category of book values and fair values of the group's financial liabilities at 31 December 2002 and 31 December 2001.

	2002		2001	
	Book value	Fair value	Book value	Fair value
	£ 000	£ 000	£ 000	£ 000
<b>Primary financial instruments held or issued to finance the group's operations</b>				
Short term financial liabilities and current portion of long term borrowings	23,233	23,751	255	255
Long term borrowings	72,000	75,738	100,233	105,191
<b>Derivative financial instruments held to manage the interest rate and currency profile</b>				
Interest rate swaps	375	1,778	266	1,256
Forward foreign exchange contracts		(165)		36
	<b>_____</b>	<b>_____</b>	<b>_____</b>	<b>_____</b>

The fair value of the interest rate swaps and forward foreign exchange contracts have been determined by reference to prices available from the markets on which the instrument involved is traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

The fair values of shareholder loans have not been presented (see note 25). As they are not publicly traded and repayment is not necessarily in cash, it would be impractical to make an estimate with sufficient reliability.

The fair values of the cumulative redeemable preference shares have not been presented. As they are not publicly traded and can be redeemed at any time at the option of the company, it would be impractical to make an estimate with sufficient reliability.

***Gains and losses on hedges***

The group enters into forward foreign currency contracts to eliminate some of the currency exposures that arise on purchases denominated in foreign currencies. It also uses interest rate swaps to manage its interest rate profile. Changes in the fair value of instruments used as hedges are not recognised in the accounts until the hedged position matures.

An analysis of these unrecognised gains and losses is as follows:

	2002		
	Gains	Losses	Net
	£ 000	£ 000	£ 000

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Unrecognised gains and losses on hedges at 1 January 2002	287	1,313	1,026
Gains and losses arising in previous years that were recognised in 2002	<u>(287)</u>	<u>(1,116)</u>	<u>(829)</u>
Gains and losses arising before 1 January that were not recognised in 2002		197	197
Gains and losses arising in 2002 that were not recognised in 2002	<u>165</u>	<u>1,206</u>	<u>1,041</u>
Unrecognised gains and losses on hedges at 31 December 2002	<u>165</u>	<u>1,403</u>	<u>1,238</u>
Of which:			
Gains and losses expected to be recognised in 2003	<u>165</u>	<u>1,251</u>	<u>1,086</u>
Gains and losses expected to be recognised in 2004 or later	<u></u>	<u>152</u>	<u>152</u>

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002**

An analysis of these unrecognised gains and losses is as follows:

	<b>2001</b>		
	<b>Gains</b>	<b>Losses</b>	<b>Net</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
Unrecognised gains and losses on hedges at 1 January 2001		340	340
Gains and losses arising in previous years that were recognised in 2001		(340)	(340)
Gains and losses arising before 1 January that were not recognised in 2001			
Gains and losses arising in 2001 that were not recognised in 2001	287	1,313	1,026
Unrecognised gains and losses on hedges at 31 December 2001	287	1,313	1,026
Of which:			
Gains and losses expected to be recognised in 2002	164	766	602
Gains and losses expected to be recognised in 2003 or later	123	547	424

**16. CALLED UP SHARE CAPITAL**

	<b>2002</b>	<b>2001</b>
	<b>£</b>	<b>£</b>
<b>Authorised:</b>		
10,000 D ordinary shares of £0.01 each	100	100
475,000 non-voting preference B shares of £0.01 each	4,750	4,750
30,000 E shares of £0.02 each	600	600
500,000,000 cumulative redeemable preference shares of £0.01 each	5,000,000	5,000,000
485,000 preference voting A shares of £0.02 each	9,700	9,700
475,000 zero dividend voting C shares of £0.01 each	4,750	4,750
	<b>5,019,900</b>	<b>5,019,900</b>
<b>Called up, allotted and fully paid</b>		
10,000 D ordinary shares of £0.01 each	100	100

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475,000 non-voting preference B shares of £0.01 each	4,750	4,750
13,500 E shares of £0.02 each	270	270
300 cumulative redeemable preference shares of £0.01 each	3	3
485,000 preference voting A shares of £0.02 each	9,700	9,700
475,000 zero dividend voting C shares of £0.01 each	4,750	4,750
	19,573	19,573
	19,573	19,573

The shareholders funds attributable to non-equity shares is the nominal value of the respective non-equity shares plus £41,098,000 (2001 £37,160,000) attributable to the cumulative redeemable preference shares.

***D Ordinary shares ( D Shares )***

D shares are entitled to receive a preferred dividend being a portion of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that dividend. Holders of D shares together with B shareholders are entitled to receive 50% of this preferred dividend.

D shareholders are also eligible to receive ordinary dividends. Holders of D shares receive 1 vote per share. On a winding-up, D shareholders together with B shareholders are eligible to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

***Non-voting preference B shares ( B shares )***

B shares are entitled to receive a preferred dividend being a portion of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that

**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002**

dividend. Holders of B shares together with D shareholders are entitled to receive 50% of this preferred dividend. B shareholders are also eligible to receive ordinary dividends. Holders of B shares have no voting rights. On a winding-up, B shareholders together with D shareholders are entitled to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

***E shares***

E shares are only entitled to receive ordinary dividends (after cumulative redeemable preference share dividends and preferred dividends to A, B and D shareholders) at the earlier of 5 years after the date of issue of the shares and the date of realisation (being flotation, sale or a winding-up). After 5 years or realisation, E shareholders are entitled to 1 vote per share. On a winding-up, they are entitled to receive a share in the surplus assets after payment to the cumulative redeemable preference shareholders and the A, B and D shareholders.

***Cumulative redeemable preference shares***

Cumulative redeemable preference shares carry an entitlement to dividend at the rate 9% per annum on the issue price and may be redeemed at £100,122 per share at any time at the option of the company. Holders of the cumulative redeemable preference shares have no voting rights. On a winding-up, the holders are entitled to receive, in priority to any other classes of shares, the sum of £100,122 per share together with any arrears of dividend.

***Preference voting A shares ( A shares )***

A shares are entitled to receive a preferred dividend of 50% of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that dividend. A shareholders are also eligible to receive ordinary dividends and receive 1 vote per share. Holders of A shares have the right on a winding-up to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

***Zero dividend voting C shares ( C shares )***

C shareholders are not entitled to receive any dividend income but have 1 vote per share. On a winding-up, they are entitled to receive a share in the surplus assets after payment to the cumulative redeemable preference shareholders and the A, B and D shareholders.

**17. RESERVES**

Group	Share premium account	Profit and loss account	Total
	£ 000	£ 000	£ 000
At 1 January 2002	30,036	(191,804)	(161,768)
Retained loss for the year		(1,942)	(1,942)
Finance costs of non-equity shares		3,938	3,938
At 31 December 2002	30,036	(189,808)	(159,772)





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Company	Share premium account	Profit and loss account	Total
	£ 000	£ 000	£ 000
At 1 January 2002	30,036	(187,104)	(157,068)
Retained loss for the year		(630)	(630)
Finance costs of non-equity shares		3,938	3,938
At 31 December 2002	30,036	(183,796)	(153,760)

**18. RECONCILIATION OF MOVEMENTS IN GROUP SHAREHOLDERS FUNDS**

	2002	2001
	£ 000	£ 000
Retained loss for the year	(1,942)	(62,536)
Finance cost of non-equity shares	3,938	3,597
Net movement to accumulated deficit	1,996	(58,939)
Opening accumulated deficit	(161,749)	(102,810)
Closing accumulated deficit	(159,753)	(161,749)

**19. RECONCILIATION OF OPERATING LOSS TO OPERATING CASH FLOWS**

	2002	2001
	£ 000	£ 000
Operating profit (loss)	4,836	(47,705)
Depreciation charges	11,286	12,038
(Increase) decrease in stocks	(744)	3,530
Increase in debtors	(4,701)	(15,931)
Increase (decrease) in creditors	24,035	(5,997)
<b>Net cash inflow (outflow) from operating activities</b>	<b>34,712</b>	<b>(54,065)</b>

**20. ANALYSIS OF CASH FLOWS**

	2002	2001
	£ 000	£ 000
<i>Returns on investments and servicing finance</i>		

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Interest received	522	483
Interest paid	(8,220)	(4,619)
Interest element of finance lease rentals	(48)	(72)
	<u>          </u>	<u>          </u>
<b>Net cash outflow</b>	<b>(7,746)</b>	<b>(4,208)</b>
	<u>          </u>	<u>          </u>
<i>Capital expenditure and financial investment</i>		
Purchase of tangible fixed assets	(18,315)	(8,836)
	<u>          </u>	<u>          </u>
<i>Financing</i>		
Share capital receipts for shares issued in previous years		14
Increase in loans secured on share capital and assets of the group		75,000
Repayment of loans secured on share capital and assets of the group	(5,000)	
Repayment of capital element of finance lease	(255)	(156)
	<u>          </u>	<u>          </u>
<b>Net cash (outflow) inflow</b>	<b>(5,255)</b>	<b>74,858</b>
	<u>          </u>	<u>          </u>

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO THE ACCOUNTS (unaudited) (Continued)****Year ended 31 December 2002****21. ANALYSIS AND RECONCILIATION OF NET DEBT**

	1 January 2002	Cash flow	Other non-cash changes	31 December 2002
	£ 000	£ 000	£ 000	£ 000
Cash in hand, at bank	9,714	3,396		13,110
Debt due after one year	(164,314)	5,000	(5,362)	(164,676)
Finance lease	(488)	255		(233)
Net debt	(155,088)	8,651	(5,362)	(151,799)

	2002	2001
	£ 000	£ 000
Increase in cash in the period	3,396	7,749
Cash used to repay debt	5,000	
Cash inflow from increase in debt		(75,000)
Cash used to repay finance lease	255	156
Change in net debt resulting from cash flows	8,651	(67,095)
Other non-cash changes	(5,362)	(6,299)
Movement in net debt in period	3,289	(73,394)
Net debt brought forward	(155,088)	(81,694)
Net debt at 31 December	(151,799)	(155,088)

The non-cash changes represent the interest on the shareholder loans that is rolled up into the principal on a quarterly basis (see note 15).

**22. FINANCIAL COMMITMENTS**

Annual minimum lease commitments:

	Group		Company	
	Land and buildings	Land and buildings	Land and buildings	Land and buildings
	2002	2001	2002	2001
	£ 000	£ 000	£ 000	£ 000
Expiry date				
within one year				

between two and five years				
after five years	1,092	1,092	240	240
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	1,092	1,092	240	240
	<b>          </b>	<b>          </b>	<b>          </b>	<b>          </b>

The group and company have £776,000 (2001 £nil) of capital commitments contracted but not provided for.

**23. PENSION ARRANGEMENTS**

The company operates a defined contribution scheme for which the pension cost charge for the year amounted to £776,000 (2001 £549,000).

**24. CONTINGENT ASSET**

As a result of a High Court judgement on 6 March 2003, Virgin Mobile will be entitled to receive certain amounts for marketing support contributions that had been previously withheld by T-Mobile. Any amounts withheld have been fully provided for in the period in which they were withheld. The amounts that will be payable will be determined following future proceedings and any future payment by T-Mobile in

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) (Continued)**

**Year ended 31 December 2002**

relation to the previous marketing support contributions withheld will be reported as turnover in the results for the period in which the amount receivable can be determined with more certainty.

**25. RELATED PARTY TRANSACTIONS**

T-Mobile, through T-Mobile (UK) Limited, and The Virgin Group, through Bluebottle Investments S.A. and Bluebottle UK Limited, are joint venture partners in Virgin Mobile. The following transactions occurred with these partners in the year.

***T-Mobile***

The company was partially financed by a loan facility provided by T-Mobile on which interest at variable rates accrues. The principal amount of £34,837,922 (2001 £32,156,945) was outstanding as at 31 December 2002. Interest has been rolled up to the principal quarterly. Total interest for the year payable to T-Mobile is £2,680,977 (2001 £2,827,303). There are no fixed repayment dates, however this loan and associated interest does not become repayable until the bank syndicated loan (see note 15) has been repaid in full.

Some handsets, service packs and other accessories are purchased by T-Mobile on behalf of the company. The total cost to the company in respect of such purchases amounted to £5,888,061 (2001 £18,116,136) and of this £3,528,125 remained unpaid as at 31 December 2002 (2001 £880,190).

T-Mobile pays a marketing support contribution to the company and the company pays charges to T-Mobile for the use of its network. The total income from marketing support contributions to the company, net of payments to T-Mobile for use of its network, amounted to £15,160,603 (2001 £10,851,585) of which a net amount of £8,538,404 (2001 £2,552,222) remained outstanding as at 31 December 2002.

T-Mobile distributes airtime vouchers to certain retailers on behalf of the company. The total amount invoiced during the period in respect of these vouchers, net of management and distribution fees, amounted to £11,716,170 (2001 £26,769,848). £1,716,815 (2001 £2,041,684) of this total remained outstanding from T-Mobile as at 31 December 2002.

T-Mobile incurred additional expenses, particularly third party recharges and staff time, which were recharged on to the company and the company incurred similar expenses which were recharged to T-Mobile. The net amount recharged by T-Mobile was £395,463 (2001 £463,179). As at 31 December 2002, a net amount of £1,464,374 was owing from the company to T-Mobile (2001 £114,200 was owing from T-Mobile to the company).

T-Mobile provides three directors of the company and receives a £45,000 (2001 £45,000) annual consultancy fee for these executive services. An amount of £63,750 (2001 £18,750) remained outstanding at the end of 31 December 2002.

***Virgin Group***

The company was partially financed by a loan facility provided by Bluebottle UK Limited, a member of the Virgin Group, on which interest at variable rates accrues. The principal amount of £34,837,922 (2001 £32,156,945) was outstanding as at 31 December 2002. Interest has been rolled up to the principal quarterly. Total interest for the year payable to companies within the Virgin Group was £2,680,977 (2001 £2,827,303). There are no fixed repayment dates, however this loan and associated interest does not become repayable until the bank syndicated loan (see note 15) has been repaid in full.

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During the period, handset, airtime vouchers and other stock items were sold through retailers who are members of the Virgin Group. These sales amounted to £22,990,506 (2001 £36,639,689) of which £7,755,801 (2001 £9,443,202) remained outstanding as at 31 December 2002.

Members of the Virgin Group performed additional services including printing, brand licensing and promotion, which were recharged on to the company. These amounted to £5,445,894 (2001 £8,300,147) of which £1,407,894 (2001 £2,532,076) remained unpaid as at 31 December 2002.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) (Continued)**

**Year ended 31 December 2002**

Virgin Management Limited provides three directors of the company and receives a £45,000 (2001 £45,000) annual consultancy fee for these executive services. An amount of £18,750 (2001 £7,500) remained outstanding at the end of 31 December 2002.

The group uses some other sundry services provided by members of the Virgin Group. These are transacted on an arm's length basis under normal commercial terms.

**26. SHAREHOLDERS CONTRACTUAL DISPUTE**

As at 31 December 2002 and 16 April 2003, there was a legal action pending between the Virgin Group shareholders and T-Mobile regarding an alleged event of default by T-Mobile under the Shareholders Agreement. The Virgin Group shareholders are seeking a declaration from the court as to whether this event of default has occurred. Should the Virgin Group shareholders succeed in this action, the Virgin Group shareholders would have the right, but not the obligation, to serve a compulsory sale notice requiring that the shares in Virgin Mobile held by T-Mobile be offered for sale to the Virgin Group shareholders. While this could have implications for Virgin Mobile's bank funding, the directors understand that the Virgin Group shareholders would not serve a compulsory sale notice without obtaining appropriate waivers, under the syndicated bank loan agreement, from the syndicated banks.

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**VIRGIN MOBILE TELECOMS LIMITED**

**US GAAP**

**CONSOLIDATED FINANCIAL STATEMENTS**

**For the years ended 31 December 2001 and 2000 and for the period  
from incorporation (29 January 1999) to 31 December 1999**

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**This report is a copy of a previously issued Arthur Andersen report and Arthur Andersen has not reissued this report.**

**REPORT OF INDEPENDENT AUDITORS**

**To the Shareholders of Virgin Mobile Telecoms Limited:**

We have audited the accompanying consolidated balance sheets of Virgin Mobile Telecoms Limited (a UK company) and subsidiary as of 31 December 2001 and 2000 and the related consolidated statements of operations, shareholders' equity and cash flows for the years ended 31 December 2001 and 2000 and for the period from its incorporation (29 January 1999) to 31 December 1999. These financial statements are the responsibility of Virgin Mobile Telecoms Limited's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Virgin Mobile Telecoms Limited and subsidiary as of 31 December 2001 and 2000, and the results of their operations and their cash flows for the year ended 31 December 2001 and 2000 and for the period from 29 January 1999 to 31 December 1999 in conformity with accounting principles generally accepted in the United States.

Arthur Andersen

6 June 2002

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****CONSOLIDATED BALANCE SHEETS****31 December 2001 and 2000**

	<b>31 December 2001</b>	<b>31 December 2000</b>
	<b>£ 000</b>	<b>£ 000</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	9,714	1,965
Accounts receivable, net of allowance for doubtful debts of £438,000 (2000 £481,000)	17,189	7,575
Due from other related companies	13,271	3,215
VAT receivable	516	5,059
Prepayments	2,773	1,955
Inventories	4,927	8,457
	<u>48,390</u>	<u>28,226</u>
Non-current assets:		
Deferred financing costs	1,528	1,936
Property and equipment, net of accumulated depreciation of £21,229,000 (2000 £9,043,000)	17,307	22,215
SIM cost deferral	6,425	3,569
	<u>25,260</u>	<u>27,720</u>
	<u>73,650</u>	<u>55,946</u>
<b>Liabilities</b>		
Current Liabilities:		
Accounts payable	21,664	12,527
Accrued liabilities	8,667	12,741
Deferred revenue	27,556	14,558
Interest rate swaps and forward foreign exchange contracts	1,292	7
Capital lease	255	
Due to other related companies	2,874	28,329
Other accounts payable	2,089	547
	<u>64,397</u>	<u>68,709</u>
Deferred revenue	6,972	5,114
Capital lease	233	
Bank loan	100,000	25,000
Due to other related companies	64,314	58,659
	<u>235,916</u>	<u>157,482</u>
Cumulative redeemable preference shares, £0.01 par value, 300 (2000 300)	37,160	33,563
<b>Shareholders equity</b>		
D ordinary shares, £0.01 par value, 10,000 (2000 10,000)		
Non-voting preference B shares, £0.01 par value, 475,000 (2000 475,000)	5	5

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E shares, £0.02 par value, 13,500 (2000 13,500)		
Preference voting A shares, £0.02 par value, 485,000 (2000 nil)	10	
Zero dividend voting C shares, £0.01 par value, 475,000 (2000 nil)	4	
Accumulated deficit	(199,445)	(135,104)
	<u>(199,426)</u>	<u>(135,099)</u>
Shareholders equity and cumulative redeemable preference shares	(162,266)	(101,536)
	<u>73,650</u>	<u>55,946</u>

The accompanying notes are an integral part of these consolidated financial statements.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****CONSOLIDATED STATEMENTS OF OPERATIONS**

31 December 2001, 2000 and 1999

	Year ended 31 December 2001	Year ended 31 December 2000	Period from incorporation to 31 December 1999 (11 month period)
	£ 000	£ 000	£ 000
<b>Revenues</b>			
Equipment revenue, net of discounts	25,782	20,013	8,175
Service revenue	137,940	47,929	719
	<u>163,722</u>	<u>67,942</u>	<u>8,894</u>
<b>Expenses</b>			
Network and equipment cost	(118,192)	(78,198)	(13,806)
General and administrative expense	(82,442)	(82,210)	(20,033)
Depreciation and amortization	(12,186)	(8,043)	(1,681)
	<u>(49,098)</u>	<u>(100,509)</u>	<u>(26,626)</u>
<b>Operating loss</b>	<u>(49,098)</u>	<u>(100,509)</u>	<u>(26,626)</u>
Interest expense	(11,789)	(5,005)	
Interest income	483	516	47
	<u>(60,404)</u>	<u>(104,998)</u>	<u>(26,579)</u>
<b>Loss before income taxes</b>	<u>(60,404)</u>	<u>(104,998)</u>	<u>(26,579)</u>
Provision for income taxes			
<b>Net loss before cumulative effect of adoption of SFAS No. 133</b>	<u>(60,404)</u>	<u>(104,998)</u>	<u>(26,579)</u>
Cumulative effect of adoption of SFAS No. 133	(340)		
	<u>(60,744)</u>	<u>(104,998)</u>	<u>(26,579)</u>
<b>Net loss</b>	<u>(60,744)</u>	<u>(104,998)</u>	<u>(26,579)</u>
Financing cost of cumulative redeemable preference shares	(3,597)	(2,921)	(606)
	<u>(64,341)</u>	<u>(107,919)</u>	<u>(27,185)</u>
<b>Net loss attributable to equity shareholders</b>	<u>(64,341)</u>	<u>(107,919)</u>	<u>(27,185)</u>

The accompanying notes are an integral part of these consolidated financial statements.

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## VIRGIN MOBILE TELECOMS LIMITED

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

31 December 2001, 2000 and 1999

	Share capital	Accumulated Deficit	Total Shareholders Funds/ (Deficit)
	£ 000	£ 000	£ 000
At incorporation			
Shares issued	5		5
Net loss attributable to equity shareholders		(27,185)	(27,185)
<b>Balance, 31 December 1999</b>	5	(27,185)	(27,180)
Net loss attributable to equity shareholders		(107,919)	(107,919)
<b>Balance, 31 December 2000</b>	5	(135,104)	(135,099)
Increase of share capital	14		14
Net loss attributable to equity shareholders		(64,341)	(64,341)
<b>Balance, 31 December 2001</b>	19	(199,445)	(199,426)

There was no other comprehensive income other than the results for the periods.

The accompanying notes are an integral part of these consolidated financial statements.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****CONSOLIDATED STATEMENTS OF CASH FLOWS****31 December 2001, 2000 and 1999**

	Year ended 31 December 2001	Year ended 31 December 2000	Period from incorporation to 31 December 1999 (11 month period)
	£ 000	£ 000	£ 000
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	(60,744)	(104,998)	(26,579)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Cumulative effective of adoption of SFAS No. 133	340		
Amortization of financing costs	408	102	
Depreciation and amortization	12,186	8,043	1,681
Add/(deduct) net changes in operating assets and liabilities:			
Accounts receivable	(9,614)	(6,049)	(1,526)
Due from other related companies	(10,056)	1,686	(4,901)
Other accounts receivable	883	(3,679)	(6,357)
Inventories	3,530	2,370	(10,827)
Accounts payable and accrued liabilities	7,594	5,767	16,962
Deferred revenue	14,856	15,885	3,787
Due to other related companies	(19,800)	14,472	18,016
Other accounts payable	2,480	328	219
Net cash used by operating activities	<u>(57,937)</u>	<u>(66,073)</u>	<u>(9,525)</u>
<b>Cash flows from investing activities</b>			
Net cash received in acquisition of subsidiary			3,429
Cash paid for property and equipment	(9,172)	(15,605)	(13,764)
Net cash used in investing activities	<u>(9,172)</u>	<u>(15,605)</u>	<u>(10,335)</u>
<b>Cash flows from financing activities</b>			
Financing costs incurred		(2,038)	
Proceeds from issuance of share capital	14		5
Proceeds from issuance of cumulative redeemable preference shares			30,036
Proceeds from unsecured loans from other related companies		49,500	1,000
Proceeds from loans secured on share capital and net assets of the group	75,000	25,000	
Repayment of capital lease	(156)		
Net cash provided by financing activities	<u>74,858</u>	<u>72,462</u>	<u>31,041</u>
<b>Net increase/(decrease) in cash and cash equivalents</b>	<b>7,749</b>	<b>(9,216)</b>	<b>11,181</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>1,965</b>	<b>11,181</b>	



<b>Cash and cash equivalents, end of year</b>	9,714	1,965	11,181
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The accompanying notes are an integral part of these consolidated financial statements.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**31 December 2001, 2000 and 1999**

**1 Background and organization**

The company was incorporated on 29 January 1999 in the United Kingdom. The principal activities of the group comprise the sale of mobile phone handsets and the provision of mobile telecommunication services.

Virgin Mobile Telecoms Limited has a 100% holding in Bluebottle Call Limited. The only activity of this company is the leasing of property on behalf of Virgin Mobile Telecoms Limited. Together these two companies form the group.

**2 Significant accounting policies**

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States and are expressed in British Pounds Sterling. The significant accounting policies are summarized as follows:

***a) Basis of preparation***

As at 31 December 2001 the group had a total shareholder deficit of £199,426,000 (2000 £135,099,000). The group is currently being financed by a syndicated bank loan (see note 4) and by its shareholders, T-Mobile and the Virgin Group (see note 8). The group has drawn down £100,000,000 under the £115,000,000 syndicated bank loan. The continued availability of this funding is based on achieving a number of financial and operating covenants (see note 4). While there can be no certainty about the group's future operating performance, based on the group's current approved plan for 2002 and forecasts for subsequent periods, the directors expect that the group will be cash neutral in the twelve months ending 31 December 2002 and that the group will comply with the syndicated bank loan covenants. Therefore, the directors have prepared these accounts on a going concern basis.

***b) Basis of consolidation***

The financial statements consolidate the financial statements of the Company and its subsidiary company after eliminating all intercompany transactions and balances.

***c) Use of estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual amounts and results could differ from those estimates.

***d) Foreign currencies***

The consolidated financial statements are prepared in British Pounds Sterling. The functional currency is local currency in which the Company and its subsidiary are located (UK). Transactions in foreign currencies are translated at the exchange rate in effect at the date of each transaction. Differences in exchange rates during the period between the date a transaction denominated in a foreign currency is consummated and the date on which it is either settled or translated are recognized in the statement of operations.

The foreign currency exchange gain or loss recognized in the statement of income was a loss of £93,000 (2000 £4,000, 1999 £nil).

*e) Cash and cash equivalents*

For purposes of the statement of consolidated cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash. No such instruments were held during the period.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**31 December 2001, 2000 and 1999**

***f) Accounts receivable trade***

Accounts receivable trade are stated at nominal value less a provision for doubtful accounts. The provision is based on the risk of non-collectability then known. Amounts written off amounted to £206,000 (2000 £97,000, 1999 £nil) and the provision decreased by £43,000 (increased by £481,000 in 2000).

***g) Revenue recognition***

*Equipment*

*Handsets*

Handsets revenue is recognized based on the amounts received, net of rebates and commissions paid to the channels, at the date of sale. Commissions payable to channels are accrued when the channel has fulfilled the conditions to which the commission relates. This revenue is considered a separate earnings process to airtime and SIM card sales and hence is recognized upon delivery to the distributor.

*SIM cards*

SIM cards are sold to channels or directly to subscribers. The sale of a SIM card represents an ongoing commitment to provide service to a subscriber over the average subscriber's life. Revenue is therefore deferred and recognized over the average subscriber life commencing at the date of sale.

*Service*

Revenue earned directly from customers is recognized based on usage of the network in the period when services are rendered. No revenue is recognized on initial free airtime. Revenue is earned from third parties for the provision of services, including the network, to Virgin Mobile customers. This revenue is recognized in the period when services are rendered.

***h) Direct costs related to revenue***

*Handset costs*

Handset costs are recognized based on the amounts paid, net of rebates received from the suppliers, at the date of sale.

*SIM cards*

Costs are deferred and recognized over the average subscriber life commencing at the date of sale. Deferred costs are included within non-current assets.

*Network charges*

Network costs including the cost of providing initial free airtime are recognized on usage of the network.

***i) Advertising costs***

Advertising costs are expensed as incurred. Such costs are included in sales and general and administrative expenses in the accompanying consolidated statements of operations and for the year ended 31 December 2001 were £17,172,000 (2000 £17,844,000, 1999 £1,626,000).

*j) Financing costs*

Debt issuance costs relating to the Company's bank loans are deferred and amortized to interest expense using the effective interest method over the term of the bank loan.

*k) Property and equipment*

Property and equipment are stated at cost, net of accumulated depreciation. Maintenance repairs and minor renewals are charged to expense as incurred. Major renewals and improvements are capitalized and

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999**

depreciated over their estimated useful lives. When assets are retired or otherwise disposed of, the cost is removed from the asset account and the corresponding accumulated depreciation is removed from the related reserve account. Any gain or loss resulting from such retirement or disposal is included in current income.

The recoverability of fixed assets is assessed whenever events or circumstances indicate a potential impairment. This assessment involves comparing the carrying value of the assets with management's best estimate of the future undiscounted cash flows to be generated by using the asset. Where this calculation indicates an impairment the asset is written down to its fair value, which is estimated based upon management's best estimate of future discounted cash flows.

Depreciation is provided on a straight-line basis over the estimated useful lives of the property and equipment as follows:

Leasehold improvements	3 years
Fixtures and fittings	3 years
Office equipment	3 years
Computer systems	2-3 years

Assets under development are not depreciated until development has been completed and the fixed asset is fully operational.

***l) Inventories***

Inventories which comprise handsets held for resale are stated at the lower of standard cost and market value. Market value is based on estimated selling price, less further direct selling costs. Provision is made for obsolete, slow-moving or defective items where appropriate.

***m) Income taxes***

Income taxes are accounted for under the liability method in accordance with FAS 109, Accounting for Income Taxes. Deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to the extent that it is more likely than not that a portion of the assets will not be realized.

***n) Derivative financial instruments***

The Company uses derivative financial instruments for the purpose of reducing its exposure to adverse fluctuations in interest rates, currencies and other market risks. The counterparties to these instruments are major financial institutions with high credit quality. The Company is exposed to credit loss in the event of non-performance by these counterparties.

On 1 January 2001, the Company adopted FAS 133, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and used for hedging activities. All derivatives, whether designated for hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, all changes in the fair value of the derivative and changes in the fair value of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of the changes

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in the fair value of the derivative are recorded in other comprehensive income and are recognized in the statement of operations when the hedged item affects earnings. The ineffective portions of both fair value and cash flow hedges are immediately recognized in earnings.

The Company's interest rate swap has never been designated as an accounting hedge, consequently upon the adoption of SFAs No 133, this swap was recorded in the balance sheet at fair value at the transition date (1 January 2001). The resulting adjustment of £340,000 was recorded as the cumulative effect of adoption of SFAs No 133.

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**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**31 December 2001, 2000 and 1999**

After adoption of FAS 133, the interest rate swaps are accounted for at fair value, marking to market (fair value) any differences between periods through the statement of operations at the end of each reporting period. Swaps contracts are recorded at fair value and any differences between periods are recorded through the statement of operations at the end of each reporting period. The charge in the period is taken as a general and administrative expense.

***n) Deferred revenue***

Deferred revenue represents:

Deferred SIM card revenue. This revenue is recognized over the average subscriber life.

The balance of services due to pre-pay customers. This revenue is recognized upon usage.

The cash payments received as an incentive to sign rental agreements. This revenue is recognized over the term of the rental agreements.

***o) Leases***

Assets obtained under capital leases are capitalised in the balance sheet and depreciated over their estimated useful lives or the leases term, whichever is shorter. The interest element of these obligations is charged to the profit and loss account over the relevant period. The capital element of the future payment is treated as a liability.

Rentals under operating leases are charged on a straight-line basis over the lease term, even if the payments are not made on such a basis. Benefits received and receivable as an incentive to sign an operating lease are similarly spread on a straight-line basis over the lease term, except where the period to the review date on which the rent is first expected to be adjusted to the prevailing market rate is shorter than the full lease term, in which case the shorter period is used.

***p) Recent accounting pronouncements***

In June 2001, the Financial Accounting Standards Board issued FAS 143 Accounting for Asset Retirement Obligations . FAS 143 requires the fair value of a liability for asset retirement obligations to be recognised in the period in which it is incurred if a reasonable estimate of the fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the related long-lived asset.

FAS 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company believes that the adoption of FAS 143 will have no impact on the company's financial statements.

In August 2001, the Financial Accounting Standards Board issued FAS 144 Accounting for the Impairment of Disposal of Long-Lived Assets to be Disposed Of . While it supersedes APB Opinion 30 Reporting the Results of operations Reporting the Effects of the Disposal of a Segment of a business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions it retains the presentation of discontinued operations but broadens that presentation to include a component of an entity (rather than a segment of a business). However, discontinued operations are no longer recorded at the net realisable value and future operating losses are no longer recognised before they occur. Under FAS 144, there is no longer a requirement to allocate goodwill to long-lived assets to be tested for impairment. It also establishes a probability weighted cash flow estimation approach to deal with situations in which there is a range of cash flows that may be generated by the asset being tested for impairment. FAS 144 also establishes criteria for determining when an asset should be



treated as held for sale.

FAS 144 is effective for fiscal years beginning after December 15 2001 and interim periods within those fiscal years, with early application encouraged. The provisions of the Statement are generally to be applied prospectively. The Company currently has no plans to dispose of any operations and, accordingly, does not anticipate that adoption of FAS 144 will have any impact on its results of operations or its financial position.

In April 2002, the FASB issued SFAS 145 Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. The principal change is that gains or

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losses from extinguishment of debt which are classified as extraordinary items by SFAS 4 will no longer be classified as such. The provisions of SFAS 145 are effective for fiscal years beginning after 15 May 2002 although early application of the Statement related to the rescission of SFAS 4 is encouraged. The Company plans to adopt SFAS 145 for its fiscal year ending 31 December 2003. When adopted, prior extraordinary items related to the extinguishment of debt will need to be reclassified.

**3 Property and equipment**

Property and equipment consist of the following:

	<u>Leasehold improvements</u>	<u>Fixtures and fittings</u>	<u>Office equipment</u>	<u>Computer systems</u>	<u>Total</u>
	£ 000	£ 000	£ 000	£ 000	£ 000
<b>Cost</b>					
At 1 January 2001	7,718	642	271	22,627	31,258
Additions	74	20	2	7,182	7,278
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
At 31 December 2001	7,792	662	273	29,809	38,536
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Depreciation</b>					
At 1 January 2001	1,591	263	78	7,111	9,043
Charge for the period	2,517	213	101	9,355	12,186
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
At 31 December 2001	4,108	476	179	16,466	21,229
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net book value</b>					
At 31 December 2001	3,684	186	94	13,343	17,307
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
At 31 December 2000	6,127	379	193	15,516	22,215
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

Property and equipment include computer equipment of £644,375 (2000 £nil) and net book value of £536,537 (2000 £nil) in respect of assets held under a capital lease.

**4 Long term debt**

The Group's long-term debt comprises the following:

	<u>2001</u>	<u>2000</u>
	£ 000	£ 000
Capital lease	233	
Bank loan	100,000	25,000
Due to other related companies	64,314	58,659
	<u>          </u>	<u>          </u>

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164,547      83,659

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As at 31 December 2001, contractual maturities of the Group's indebtedness were as follows:

	Capital lease	Bank loan	Due to other related companies
	£ 000	£ 000	£ 000
<b>Year ended 31 December</b>			
2002	255		
2003	233	23,000	
2004		46,000	
2005		31,000	
2005 or later			64,314
	<hr style="width: 50px; margin: auto;"/>	<hr style="width: 50px; margin: auto;"/>	<hr style="width: 50px; margin: auto;"/>
<b>Total</b>	488	100,000	64,314
	<hr style="width: 50px; margin: auto;"/>	<hr style="width: 50px; margin: auto;"/>	<hr style="width: 50px; margin: auto;"/>

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999**

The bank loan is in the form of a syndicated loan facility. The loan facility is secured on the share capital and assets of the group. The interest rate on the floating rate element of the facility loan is linked to the LIBOR. The undrawn committed borrowings under this facility at 31 December 2001 was £15,000,000 (2000 £55,000,000). The continued availability of this facility is based on achieving a number of financial and operating covenants, the principal covenants being subscriber numbers and revenue and earnings to debt ratios.

The interest rate on floating shareholder loans for which there is no fixed repayment date is at 4% above the three-month LIBOR rate. These loans and associated interest do not become repayable until the bank has been repaid.

**5 Shareholders equity**

	2001	2000
	£	£
<i>Authorised</i>		
10,000 D ordinary shares of £0.01 each	100	100
475,000 non-voting preference B shares of £0.01 each	4,750	4,750
30,000 E shares of £0.02 each	600	600
485,000 preference voting A shares of £0.02 each	9,700	9,700
475,000 zero dividend voting C shares of £0.01 each	4,750	4,750
	19,900	19,900

	2001	2000	
	Called-up and fully paid	Called-up and fully-paid	Called-up
	£	£	£
<i>Allotted</i>			
10,000 D ordinary shares of £0.01 each	100	100	100
475,000 non-voting preference B shares of £0.01 each	4,750	4,750	4,750
13,500 E shares of £0.02 each	270	270	270
485,000 preference voting A shares of £0.02 each	9,700		9,700
475,000 zero dividend voting C shares of £0.01 each	4,750	2	4,750
	19,570	5,122	19,570

*D Ordinary shares ( D shares )*

D shares are entitled to receive a preferred dividend being a portion of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that dividend. Holders of D shares together with B shareholders are entitled to receive 50% of this preferred dividend.

D shareholders are also eligible to receive ordinary dividends. Holders of D shares receive 1 vote per share. On a winding-up, D shareholders together with B shareholders are eligible to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

*Non-voting preference B shares ( B shares )*

B shares are entitled to receive a preferred dividend being a portion of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that dividend. Holders of B shares together with D shareholders are entitled to receive 50% of this preferred dividend.

B shareholders are also eligible to receive ordinary dividends. Holders of B shares have no voting rights. On a winding-up, B shareholders together with D shareholders are entitled to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999*****E shares***

E shares are only entitled to receive ordinary dividends (after cumulative redeemable preference share dividends and preferred dividends to A , B and D shareholders) at the earlier of 5 years after the date of issue of the shares and the date of realisation (being flotation, sale or a winding-up). After 5 years or realisation,

E shareholders are entitled to 1 vote per share. On a winding-up, they are entitled to receive a share in the surplus assets after payment to the cumulative redeemable preference shareholders and the A , B and D shareholders.

***Preference voting A shares ( A shares )***

A shares are entitled to receive a preferred dividend of 50% of the first £100 million to be distributed after payment of cumulative redeemable preference share dividends and any arrears of that dividend. A shareholders are also eligible to receive ordinary dividends and receive 1 vote per share. Holders of A shares have the right on a winding-up to receive, after payment to the cumulative redeemable preference shareholders, a 50% share in the first £100 million to be distributed together with an equal share of any remaining surplus assets.

***Zero dividend voting C shares ( C shares )***

C shareholders are not entitled to receive any dividend income but have 1 vote per share. On a winding-up, they are entitled to receive a share in the surplus assets after payment to the cumulative redeemable preference shareholders and the A , B and D shareholders.

**6 Cumulative redeemable preference shares**

Cumulative redeemable preference shares carry an entitlement to dividend at the rate 9% per annum on the issue price (being £30,036,000 paid in 1999) and may be redeemed at £100,122 per share at any time at the option of the company. Holders of the cumulative redeemable preference shares have no voting rights. On a winding-up, the holders are entitled to receive, in priority to any other classes of shares, the sum of £100,122 per share together with any arrears of dividend because the holders of the cumulative redeemable preference shares are the shareholders in, and have joint control of, the Company redemption is not under the control of the Company and according to EITF topic D-98, cumulative redeemable preference shares have not been classified as share capital. The following table presents a reconciliation of the carrying amount of the cumulative redeemable preference shares as of 31 December 2001, 2000 and 1999:

	<b>31 December 2001</b>	<b>31 December 2000</b>	<b>31 December 1999</b>
	<b>£ 000</b>	<b>£ 000</b>	<b>£ 000</b>
Balance, beginning of the year/period	33,563	30,642	
Share capital			
Share premium			30,036
Financing cost cumulative dividend	3,597	2,921	606
Balance, end of the year	<b>37,160</b>	<b>33,563</b>	<b>30,642</b>

**7 Financial instruments**

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The company believes the amounts presented for financial instruments in the accompanying financial statements, consisting of cash equivalents, accounts receivables, accounts payables, are reasonable estimates of their fair value.

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999**

The following table presents the carrying amounts and fair values at the Company's other financial instruments as of 31 December 2001 and 2000:

	2001			2000		
	Principal Amount	Carrying Amount	Fair Value	Principal Amount	Carrying Amount	Fair Value
	£ 000	£ 000	£ 000	£ 000	£ 000	£ 000
Long-term debt	100,233	100,233	105,191	25,000	25,000	26,797
Interest rate swap	75,000	(1,256)	(1,256)	20,000	(7)	(347)
Forward contract	6,250	(36)	(36)			

There were no financial instruments used in the year ended 31 December 1999.

The company has entered into interest rate swaps to hedge against adverse movements in LIBOR in relation to its syndicated loan facility. The company's policy is to keep between 50 per cent and 75 per cent of the syndicated loan borrowing at fixed rates of interest. At the year-end, 75 per cent of the syndicated loan was at fixed rates after taking account of interest rate swaps.

About one-third of the handset purchases made by the company are from suppliers in continental Europe. These purchases are invoiced in Euros. The company's policy is to eliminate some currency exposure on payments at the time of purchase through forward currency contracts. All other purchases are denominated in sterling.

The fair value of the interest rate swaps and foreign exchange contracts have been determined by reference to prices available from the markets on which the instrument involved is traded.

The fair value of the long term loan has been calculated by discounting cash flows at prevailing interest rates.

The fair values of shareholder loans have not been presented. As they are not publicly traded, it would be impractical to make an estimate with sufficient reliability.

The fair values of the cumulative redeemable preferences shares have not been presented. As they are not publicly traded and can be redeemed at any time at the option of the company, it would be impractical to make an estimate with sufficient reliability.

**8 Taxes**

The provision for income taxes is comprised of the following:

31 December 2001	31 December 2000	31 December 1999
£ 000	£ 000	£ 000



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Current tax payable			
Deferred tax asset due to property, plant and equipment	6,189	2,374	279
Deferred tax asset for carried forward losses	52,311	36,999	7,297
Cumulative valuation allowance	(58,500)	(39,373)	(7,576)
	<u>          </u>	<u>          </u>	<u>          </u>
	<b>          </b>	<b>          </b>	<b>          </b>

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999**

The reconciliation of the tax expense with the product of accounting multiplied by the applicable tax rate is as follows:

	Year ended 31 December 2001	Year ended 31 December 2000	11 month period ended 31 December 1999
	£ 000	£ 000	£ 000
Loss before income taxes	(60,404)	(104,998)	(26,579)
Effective tax (rate 30%)	18,121	31,499	7,974
Tax effect of accelerated capital allowances	(3,815)	(2,095)	(279)
Tax effect of permanent differences (disallowable expenses)	1,006	298	(398)
Tax credit for the period	15,312	29,702	7,297
Valuation allowance for the period	(15,312)	(29,702)	(7,297)
Tax expense for the period	—	—	—

Total carried forward tax losses at 31 December 2001 were in the region of £174,000,000 (2000 £123,000,000, 1999 £24,000,000). These losses result in significant deferred tax assets, however management believes that recognition of these assets is not appropriate given the current position of the company.

**9 Related party transactions**

T-Mobile (formerly known as One 2 One), through One 2 One Personal Communications Limited, and The Virgin Group, through Bluebottle Investments S.A. and Bluebottle UK Limited, are joint venture partners in Virgin Mobile. The following transactions occurred with these partners in the year.

**T-Mobile**

The company was partially financed by a loan facility provided by T-Mobile on which interest at variable rates accrues. The principal amount of £32,156,945 (2000 £29,329,643) was outstanding as at 31 December 2001. Interest has been rolled up to the principal quarterly. Total interest for the year payable to T-Mobile is £2,827,303 (2000 £2,627,874). There are no fixed repayment dates, however this loan and associated interest does not become repayable until the bank syndicated loan (see note 4) has been repaid.

Some handsets, service packs and other accessories are purchased by T-Mobile on behalf of the company. The total cost to the company in respect of such purchases amounted to £18,116,136 (2000 £55,366,696) and of this £880,190 remained unpaid as at 31 December 2001 (2000 £28,088,902).

T-Mobile pay a marketing support contribution to the company and the company pays charges to T-Mobile both as a result of Virgin Mobile's customers' use of the network. The total income from marketing support contributions to the company, net of payments to T-Mobile for use of its network, amounted to £10,851,585 (2000 £2,307,600) of which a net amount of £2,552,222 (2000 £1,146,643) remained outstanding as at

31 December 2001.

T-Mobile distribute airtime vouchers to certain retailers on behalf of the company. The total amount invoiced during the period in respect of these vouchers, net of management and distribution fees, amounted to £26,769,848 (2000 £13,512,352). £2,041,684 (2000 £4,400,690) of this total remained outstanding from T-Mobile as at 31 December 2001.

T-Mobile incurred additional expenses, particularly third party recharges and staff time, which were recharged on to the company and the company incurred similar expenses which were recharged to T-Mobile. The net amount recharged by T-Mobile was £463,179 (2000 £1,828,440). As at 31 December, a net amount of £114,200 was owing from T-Mobile to the company (2000 £230,000 was owing from the company to T-Mobile).

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**Table of Contents****VIRGIN MOBILE TELECOMS LIMITED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****31 December 2001, 2000 and 1999**

T-Mobile provides three directors of the company and receives a £45,000 (2000 £45,000) annual consultancy fee for these executive services. An amount of £18,750 (2000 £64,000) remained outstanding at the end of December 2001.

**Virgin Group**

The company was partially financed by a loan facility provided by Bluebottle UK Limited, a member of the Virgin Group, on which interest at variable rates accrues. The principal amount of £32,156,945 (2000 £29,329,643) was outstanding as at 31 December 2001. Interest has been rolled up to the principal quarterly. Total interest for the year payable to companies within the Virgin Group was £2,827,303 (2000 £2,079,643). There are no fixed repayment dates, however this loan and associated interest does not become repayable until the bank syndicated loan (see note 4) has been repaid.

During the period, handset, airtime vouchers and other stock items were sold through retailers who are members of the Virgin Group. These sales amounted to £36,639,689 (2000 £33,909,281) of which £9,443,202 (2000 £3,197,681) remained outstanding as at 31 December 2001.

Members of the Virgin Group performed additional services including printing, brand licensing and promotion, which were recharged on to the company. These amounted to £8,300,147 (2000 £8,364,958) of which £2,532,076 (2000 £580,230) remained unpaid as at 31 December 2001.

Virgin Management Limited provides three directors of the company and receives a £45,000 (2000 £45,000) annual consultancy fee for these executive services. An amount of £7,500 (2000 £64,000) remained outstanding at the end of December 2001.

The group uses some other sundry services provided by members of the Virgin Group. These are transacted on an arm's length basis under normal commercial terms.

**10 Financial Commitments**

Annual commitments under non-cancellable operating leases are as follows:

	<b>Land and Buildings 2001</b>	<b>Land and Buildings 2000</b>
	<b>£ 000</b>	<b>£ 000</b>
2002	1,092	1,092
2003	1,092	1,092
2004	1,092	1,092
2005	1,092	1,092
2006 or later	8,713	9,816
	<b>13,081</b>	<b>14,184</b>



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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**For the years ended 31 December 2002 and 2001**

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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**AS OF DECEMBER 31, 2002 AND 2001**

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)	A-156
STATEMENT OF CHANGES IN EQUITY (UNAUDITED)	A-157
CONSOLIDATED CASH FLOW STATEMENTS (UNAUDITED)	A-158
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)	A-159

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**INCOME STATEMENT OF**  
**COMDIRECT BANK GROUP**  
**ACCORDING TO IAS (UNAUDITED)**

	Notes	1.1.-31.12.2002	1.1.-31.12.2001
		( thousand)	( thousand)
<b>INCOME STATEMENT</b>			
Interest income		99,220	138,621
Interest expenses		35,324	64,538
Net interest income before provisions	(21)	63,896	74,083
Provision for possible loan losses	(22)	(2,037)	(2,074)
Net interest income after provisions		61,859	72,009
Commission income		79,024	96,957
Commission expenses		1,882	3,939
Net commission income	(23)	77,142	93,018
Trading profit/loss	(24)	(285)	(29)
Result from financial investments		1,200	344
Administrative expenses	(25)	138,138	224,317
Other operating result	(26)	2,917	6,659
<b>Profit from ordinary activities</b>		<b>4,695</b>	<b>(52,316)</b>
Extraordinary results and restructuring costs	(27)	(23,295)	(98,264)
<b>Pre-tax profit/loss</b>		<b>(18,600)</b>	<b>(150,580)</b>
Taxes on income	(28)	(8,836)	10,077
<b>After-tax profit/loss</b>		<b>(9,764)</b>	<b>(160,657)</b>
<b>Net loss</b>		<b>(9,764)</b>	<b>(160,657)</b>
Transfer to reserves/Transfer from reserves		9,764	160,657
<b>Consolidated profit/loss</b>		<b>0</b>	<b>0</b>

**EARNINGS PER SHARE**

	1.1.-31.12.2002	1.1.-31.12.2001
<b>EARNINGS PER SHARE</b>		
Net loss	(9,764)	(160,657)
( thousand)		
Average number of ordinary shares	140,500,000	140,500,000
Shares		
<b>Basic earnings per share</b>	<b>(0.07)</b>	<b>(1.14)</b>
1.1.-31.12.2002		1.1.-31.12.2001

**DILUTED EARNINGS PER SHARE**

Net loss	( thousand)	(9,764)	(160,657)
Adjustment to the number of ordinary shares issued due to outstanding option rights	Shares	395,349	97,278
Weighted average shares outstanding (diluted)	Shares	140,895,349	140,597,278
<b>Diluted earnings per share</b>		<b>(0.07)</b>	<b>(1.14)</b>

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**BALANCE SHEET OF**  
**COMDIRECT BANK GROUP**  
**ACCORDING TO IAS (UNAUDITED)**

ASSETS	Notes	as of 31.12.2002	as of 31.12.2001
		( thousand)	( thousand)
Cash reserve	(29)	5,181	72,005
Claims on banks	(30)	1,294,419	1,684,112
Claims on customers	(31)	175,421	263,728
Provision for possible loan losses	(32)	(6,355)	(4,936)
Trading assets	(33)	0	2,164
Financial investments	(34)	1,057,701	861,212
Intangible assets	(35)	14,094	22,076
Fixed assets	(36)	28,175	45,816
Tax assets	(38)	11,701	9,634
Other assets	(39)	8,936	18,200
<b>Total assets</b>		<b>2,589,273</b>	<b>2,974,011</b>

LIABILITIES AND EQUITY	Notes	as of 31.12.2002	as of 31.12.2001
		( thousand)	( thousand)
Liabilities to banks	(40)	14,913	0
Liabilities to customers	(41)	1,948,680	2,289,327
Provisions	(42)	21,108	51,351
Tax liabilities	(43)	0	10,444
Other liabilities		24,247	28,162
Subordinated capital	(44)	16,617	16,617
<b>Equity</b>		<b>563,708</b>	<b>578,110</b>
Subscribed capital		140,500	140,500
Capital reserve		367,221	394,327
Retained earnings			
Other revenue reserves		55,658	42,200
Revaluation reserve		329	1,083
Consolidated profit/loss		0	0
<b>Total liabilities and equity</b>		<b>2,589,273</b>	<b>2,974,011</b>

**Table of Contents****STATEMENT OF CHANGES IN EQUITY****OF COMDIRECT BANK GROUP  
(UNAUDITED)**

	Subscribed capital	Capital reserve	Retained earnings	Revaluation reserve	Consolidated profit/loss	Total 2002	Total 2001
				( thousand)			
<b>Equity as of 1.1</b>	<b>140,500</b>	<b>394,327</b>	<b>42,200</b>	<b>1,083</b>	<b>0</b>	<b>578,110</b>	<b>739,698</b>
Booking of valuation differences due to swap transactions pursuant to IAS 39			0		0	0	(2,646)
Changes in revaluation reserve pursuant to IAS 39			0	(754)	0	(754)	1,083
Appropriation of consolidated loss			0		0	0	0
Consolidated profit/loss			0		0	0	(160,657)
Changes in differences arising from currency translation			(1,635)		0	(1,635)	632
Transfer from reserves/allocation to reserves		(27,106)	15,093		0	(12,013)	0
<b>Equity as of 31.12</b>	<b>140,500</b>	<b>367,221</b>	<b>55,658</b>	<b>329</b>	<b>0</b>	<b>563,708</b>	<b>578,110</b>

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**CASH FLOW STATEMENT**  
**OF COMDIRECT BANK GROUP**  
**(UNAUDITED)**

	1.1.-31.12.2002	1.1.-31.12.2001
	( thousand)	
<b>Cash and cash equivalents as at the end of the previous period</b>	<b>72,005</b>	<b>515</b>
Cash flow from operating activities	(57,609)	91,321
Cash flow from investing activities	1,043	(7,394)
Cash flow from financing activities	0	(13,069)
Effects from deconsolidation	(8,623)	0
Effects of changes in exchange rates	(1,635)	632
	5,181	72,005
<b>Cash and cash equivalents as at the end of the period</b>	<b>5,181</b>	<b>72,005</b>

Cash and cash equivalents correspond to the balance-sheet item Cash reserve and include cash on hand and balances held at central banks.

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**COMDIRECT BANK GROUP**

**NOTES (UNAUDITED)**

**Basis of accounting principles**

The consolidated financial statements of comdirect bank as of 31 December, 2002 were prepared in accordance with the International Accounting Standards (IAS), which were approved and published by the International Accounting Standards Committee (IASC) and interpreted by the Standing Interpretations Committee (SIC).

A summary of all the regulations that have been applied can be found on pages 43 44.

As a subsidiary of Commerzbank AG, Frankfurt am Main, we are exempted in accordance with Art. 291 of the German Commercial Code (HGB), from the duty to present sub-group financial statements. As we have not presented the main differences between financial statements prepared in accordance with IAS and those prepared in accordance with the German Commercial Code, these consolidated financial statements do not conform to the 4th and 7th EC directives and do not, therefore, exempt us from presenting consolidated financial statements in accordance with Art. 292a, HGB. The consolidated financial statements have been prepared in order to satisfy the admission requirements/subsequent requirements of the Deutsche Börse AG for the Neuer Markt.

The consolidated financial statements also reflect the standards approved by the German Accounting Standards Board (GASB) and published by the German Federal Ministry of Justice pursuant to Art. 342, (2), HGB.

The comdirect sub-group is included in the consolidated financial statements of our parent company. The consolidated financial statements of Commerzbank as of 31 December, 2001 were deposited with the lower regional court (Amtsgericht) of Frankfurt am Main under the commercial register no. 32000 and published in the Federal Gazette, no. 110, page 8077 and following of 19 June, 2002.

We report on both the implementation of the German legislation for control and transparency in the corporate sector (KonTraG) and on the risks posed by future development, pursuant to Art. 315, (1), HGB in the risk report as part of the Group management report.

In addition to the income statement and the balance sheet, the consolidated financial statements also include the statement of changes in equity, the cash flow statement and the notes. Segment reporting appears as part of the notes, on page 67 (note no. 49).

Unless otherwise indicated, all the amounts are shown in thousands of euros.

**Accounting and measurement methods**

**(1) Basic principles**

The consolidated financial statements of comdirect are based on the going concern principle.

The principle of profit or loss for the period is applied in our consolidated financial statements. Income and expenses are recognised on a pro-rata basis; they are shown for the period to which they may be assigned in economic terms.

As a matter of principle, accounting is at net book value, with the exception of financial instruments as defined by IAS 39, which are shown at their fair value. These financial instruments appear under the balance-sheet item Financial investments. All financial instruments are shown in the balance sheet according to

the method trade date accounting.

All the companies included in the consolidation prepared their financial statements as of 31 December, 2002.

**(2) IAS, SIC and GASB rules applied**

Within the comdirect Group and within the Commerzbank Group, to which it belongs, only those IASs and SICs are applied for accounting and measurement purposes, which had been approved and published by 31 December, 2002.

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**Table of Contents****COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

The following list provides a summary of the International Accounting Standards (IAS) applied in comdirect's 2002 Group financial statements.

IAS 1	Presentation of financial statements
IAS 7	Cash flow statements
IAS 8	Net profit or loss for the period, fundamental errors and changes in accounting policies
IAS 10	Events after the balance-sheet date (uncertainties of success and events after the balance-sheet date)
IAS 12	Income taxes
IAS 14	Segment reporting
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 21	The effects of changes in foreign exchange rates
IAS 22	Business combinations
IAS 24	Related party disclosures
IAS 26	Accounting and reporting by retirement benefit plans
IAS 27	Consolidated financial statements and accounting for investments in subsidiaries
IAS 30	Disclosures in the financial statements of banks and similar financial institutions
IAS 32	Financial instruments: disclosure and presentation
IAS 33	Earnings per share
IAS 35	Discontinued operations
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments: recognition and measurement

The following list provides the SIC interpretations relevant for comdirect, which in addition to the Standards we have taken into consideration in our 2002 Group financial statements.

		Relates to:
SIC-6	Costs of modifying existing software (framework)	IAS Framework
SIC-7	Introduction of the euro	IAS 21
SIC-12	Consolidation special purpose entities	IAS 27
SIC-15	Operating leases incentives	IAS 17
SIC-17	Equity costs of an equity transaction	IAS 32
SIC-18	Consistency alternative methods	IAS 1

**(3) Consolidated companies**

Apart from the parent company, the consolidated companies consist of one subsidiary, comdirect Ltd, London/ Great Britain and one special fund, a special purpose entity (SPV) in accordance with SIC-12. comdirect bank AG holds 100% of the shares of comdirect Ltd. A detailed presentation of holdings appears on page 71.

**(4) Principles of consolidation**

The consolidation of the capital accounts is based on the book-value method, whereby the historical cost of the shares held by the parent company in each individual subsidiary and the share of each subsidiary's capital held by the parent company are set off against the proportion of the subsidiary's equity that was acquired.





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**COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

Intra-group expenses and income, as well as claims and liabilities, are eliminated as part of the consolidation.

On 25 February, 2002, the partners of comdirect bank S.p.A., Milan/ Italy decided on the liquidation of the company. As a result, the company is to be excluded from the consolidation according to International Accounting Standards.

Also no longer included in the consolidation was comdirect S.A., Paris/ France, which was transferred to ProCapital S.A. on 8 April, 2002.

As defined by the true and fair view approach, the deconsolidation of the companies was done effective 1 January, 2002.

**(5) Currency translation**

The items from the income statement and also the assets and liabilities from the balance sheet which are denominated in foreign currencies are translated at the spot rates of the balance-sheet date.

Holdings in affiliated companies that are denominated in foreign currencies appear at historical acquisition costs.

comdirect nets translation gains and losses from the consolidation of the capital accounts against retained earnings.

The annual financial statement prepared by our subsidiary in foreign currency is translated at the spot rates of the balance-sheet date. Any income and expenses resulting from this appear in the income statement.

The most important exchange rate for the comdirect Group is the British pound (GBP). The GBP exchange rate as of 31 December, 2002 was 0.6500 (previous year: 0.6085).

**(6) Claims**

All claims on banks and customers are shown at amortised costs without valuation allowances.

Valuation allowances to claims appear under provisions for possible loan losses.

On the balance-sheet date, we had no acquired claims, i.e., sections of a credit originated by another lender, in our portfolio.

**(7) Provision for possible loan losses**

Valuation allowances, in the form of individual and lump sum valuation allowances, are formed exclusively for claims on customers.

Throughout the Group, the relevant individual valuation allowances are formed on the scale of the potential default to cover credit-standing risks related to claims on customers.

We cover latent credit risks by means of lump sum valuation allowances. Past loan losses serve as a yardstick for the scale on which such lump sum valuation allowances have to be formed.

Unrecoverable accounts are written down immediately. Amounts received on such claims appear in the income statement. Claims are deemed unrecoverable if income from them is unlikely to be received in the foreseeable future or if they have been waived either wholly or in part.

**(8) Financial investments**

Under Financial investments, we show all the securities, which we have assigned to the available for sale category.

On the balance-sheet date, all bonds, other fixed-income securities, equities, and other variable-yield securities (investment fund shares) not held for trading purposes were assigned to the available for sale category.

All the securities of this category were measured at their fair value.

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**COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

Gains or losses on remeasurement are recognised with an income-neutral effect in the form of a revaluation reserve as part of equity, taking into account deferred taxes.

The earnings resulting from the sale or maturity of financial instruments, which are attributable to the category available for sale, amounted to 1,510 thousand at the end of the financial year 2002. Corresponding losses amounted to 310 thousand.

All the interest income generated by securities of the available for sale category is shown in the income statement under Interest income.

This interest income amounts to 36,619 thousand at the end of the financial year 2002.

**(9) Intangible assets**

Under Intangible assets we exclusively include specialised software produced in-house. Purchased software is shown under Fixed assets.

Software produced in-house is recognised if all the provisions of IAS 38 are met. Recognition is made at producer cost.

In principle software produced in-house is amortised against earnings over a period of five years.

Extraordinary write-offs are shown in the year under review in the income statement under Extraordinary results and restructuring costs.

**(10) Fixed assets**

The balance-sheet item Fixed assets comprises land and buildings, office furniture and equipment and purchased software.

All the fixed assets are capitalised at cost. Office furniture and equipment as well as purchased software are depreciated using the straight-line method to reflect their probable useful economic lives.

In determining the useful economic life of an asset, its likely physical wear and tear, its technical obsolescence as well as legal restrictions are taken into consideration. All fixed assets are depreciated over a period of three to ten years.

Gains and losses arising from the sale of fixed assets are shown in the income statement under Other operating result.

We made extraordinary depreciations on fixed assets in the year under review when the amount that could probably be achieved through future use had fallen below their book value.

**(11) Other assets**

Other assets mainly consist of other assets on Commerzbank AG and deferred items.

**(12) Liabilities**

Liabilities are shown at the respective amounts to be repaid.

**(13) Other liabilities**

Other liabilities consist of liabilities to Commerzbank not arising from banking activities, trade liabilities, tax liabilities not related to earnings and accruals.

**(14) Provisions for pensions and similar commitments**

The pension commitments shown exist towards three members of the Board of Managing Directors and two former members of the Board of Managing Directors of comdirect bank AG. The commitments are based on the years of service, the pensionable salary and the current scales for employer subsidies.

In accordance with IAS 19, the projected unit-credit method was used to calculate pension commitments.

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**COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

Commitments are calculated on the basis of actuarial surveys. The calculation also takes into account the rates of increase for salaries and pensions that can be expected in the future.

If actuarial commitments prove to be higher or lower, these are recognised under Personnel costs.

**(15) Other provisions**

Other provisions were formed for liabilities of uncertain amount towards third parties.

In addition, we have formed provisions for contingent losses for existing adverse agreements, in which the expense required in order to fulfil the agreement is greater than the income generated by the agreement.

The majority of provisions for contingent losses were formed on account of restructuring measures with the scope of implementing our com one programme for the future.

**(16) Taxes on income**

Tax expenses are shown effecting the current result under Taxes on income. A breakdown of this item into current and deferred taxes on income can be found in these notes on page 54, note 28.

Deferred taxes were formed in accordance with IAS 12. Temporary differences are the result of the discrepancy between assigned values in accordance with IAS and the respective tax rate that was applied. These temporary differences are measured using the specific income-tax rates which apply in the country where the company in question has its seat and which can be expected to apply for the period in which they are realised. Deferred taxes on the credit side on as yet unused losses carried forward are shown in comdirect bank AG.

Deferred tax assets and liabilities are netted against one another in Germany, as they exist towards the same tax authority.

Claims on tax authorities are shown under Tax assets in the balance sheet.

Other taxes not related to income appear under Other operating result in the income statement.

When the profit-and-loss-transfer agreement was terminated on 31 December, 1999, it was assumed with the agreement of the tax authorities that, for accounting purposes, the integrated inter-company relationship between comdirect bank AG and Commerzbank AG had ceased to exist. In a final judgement in the fourth quarter 2001, it was decided that this relationship continued to exist as regards turnover and trade tax for the 2000 and 2001 assessment periods.

As a result of the amendments to Germany's legislation on the further development of corporate taxation, the fiscal unity in terms of trade tax ended on 31 December, 2001.

Consequently, fiscal unity was maintained only with regard to turnover tax in the 2002 financial year.

**(17) Conditional and authorised capital**

Through the resolution adopted on 10 April, 2001, and its entry into the commercial register on 19 April, 2000, authorised capital of 60,000 thousand was created. The authorisation for the capital increase expires on 31 May, 2005.

In addition, since the resolution adopted on the same date and entered into the commercial register on 31 May, 2000, conditional capital of 3,600 thousand was created in order to issue subscription rights as part of the bank's stock option scheme.

**(18) Transfer from reserves**

We charged the annual net loss incurred in the financial year 2002 in the amount of 9,764 thousand against the reserves.

As part of the deconsolidation of comdirect bank S.p.A. and comdirect S.A., a debit from the reserves is recorded in the amount of 2,249 thousand.

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**COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

**(19) Earnings per share**

Earnings per share calculated in accordance with IAS 33 are based on the net profit/loss for the year. We show both the earnings per share and the diluted earnings per share below the income statement.

In working out the earnings per share, we have set off the net profit/loss for the year against the average number of shares in the financial year.

The diluting effects result from a stock option scheme launched in July 2000 with a maximum of 3,600,000 subscription rights, of which approximately 1.8 million option rights had been issued in three tranches per 31 December, 2002.

In calculating the diluted results, we also set off the two sub-sets of rights under the stock option scheme with their conditions against well-founded estimated values for them and took account of the residual amount.

Each no par value bearer share carries a proportion of the share capital in the sum of one euro.

**(20) Relations with affiliated companies**

comdirect uses services provided by Commerzbank AG through a general agreement concluded in December 1999 (and effective as from 1 January, 1999), as well as services agreed separately on this basis.

The general agreement has a fixed term of five years and ends on 31 December, 2003. It is automatically extended for a further period of three years, unless one of the parties to the agreement gives notice at least 18 months before the agreement expires.

On the basis of the general agreement, the following services were agreed upon and were used during the 2002 financial year:

Trading services

Processing services

Payments and cash dispenser service

IT services

Other services

In February 2000, comdirect concluded another general agreement with Commerzbank, in which Commerzbank undertook to provide internal auditing services on the basis of a plan to be agreed separately. The agreement was concluded for an indefinite period and may be terminated giving six months' notice before the end of the calendar year, but not before 31 December, 2002.

comdirect is party to an agreement of Commerzbank with Commerzbank Capital Markets, respectively Brown Brothers Harriman, enabling comdirect to trade on US stock exchanges.

On 22 March, 2000, comdirect concluded an agreement with Commerzbank concerning support for comdirect after its IPO. Among other things, the agreement relates to support for PR activities, compliance with stock exchange and other obligations resulting from admission to the stock exchange and advice on the holding of the public annual general meeting of shareholders.



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In May 2000, comdirect concluded a general agreement with Commerzbank regarding security loans, on which basis comdirect lent securities to Commerzbank in the financial year.

comdirect currently offers its customers approximately 4,200 funds from more than 70 investment companies, including investment companies of the Commerzbank Group. In the 2002 financial year, comdirect received commissions on portfolio holdings and sales at prevailing market rates from the investment companies of the Commerzbank Group.

Commerzbank received compensation in line with market rates for the goods and services it provides for comdirect.

When forming comdirect ltd, London/ Great Britain, comdirect pledged to ensure compliance with the specific equity capital requirements of that country.

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

In this context, comdirect ltd received equity of 10,537 thousand in the 2002 financial year.

comdirect ltd concluded an agreement with Lloyds TSB Bank plc regarding the provision of services in securities dealings. In this context, comdirect has written a guarantee bond vis-à-vis Lloyds TSB Bank plc, submitted with a maximum amount of £3m, which can be drawn upon by written request. Vis-à-vis the additional guarantor, Commerzbank AG, London Branch, comdirect submitted a letter of indemnity in the case a claim is made on the guarantee bond written by Commerzbank AG. Both agreements were concluded on 1 October, 2002.

**(21) Net interest income**

	2002	2001
	( thousand)	
Interest and dividends from shares and other non-fixed interest securities held in the available for sale portfolio	1,004	18,589
Interest income from fixed-income securities held in the available for sale portfolio and from government-inscribed debt	35,615	43,143
Other interest income including discount surplus	62,601	76,889
Interest on profit-sharing certificates outstanding and subordinated liabilities	(840)	(1,050)
Other interest expenses	(34,484)	(63,488)
<b>Total</b>	<b>63,896</b>	<b>74,083</b>

**(22) Provision for possible loan losses**

The provisions of the comdirect Group break down as follows:

	2002	2001
	( thousand)	
Allocations to provisions	(3,485)	(4,215)
Write-back of provisions	1,556	2,356
Direct write-downs	(118)	(222)
Income received on written-down claims	10	7
<b>Total</b>	<b>(2,037)</b>	<b>(2,074)</b>

**(23) Net commission income**

	2002	2001
	( thousand)	
Securities transactions	75,659	89,316
Payment transactions	1,406	3,335

Other commissions	77	367
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>77,142</b>	<b>93,018</b>
	<u>          </u>	<u>          </u>

**(24) Trading profit**

All the financial instruments assigned to the Assets held for trading purposes are measured at fair value. The results arising from trading activities are included along with interest and dividend income, attributable to instruments shown under Assets held for dealing purposes, in the Trading profit.

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

	2002	2001
	( thousand)	
<b>Result of securities trading</b>	(134)	(332)
Result from trading in both bonds and notes	0	9
Result from trading in shares and debentures	(134)	(341)
<b>Other trading result</b>	<b>787</b>	<b>(726)</b>
Result from trading in interest-rate risks	787	(726)
<b>Valuation result</b>	<b>(938)</b>	<b>1,029</b>
Interest-rate derivatives	(938)	1,029
	(285)	(29)
<b>Total</b>	<b>(285)</b>	<b>(29)</b>

**(25) Administrative expenses***Personnel costs*

	2002	2001
	( thousand)	
Wages and salaries	(32,263)	(42,484)
Compulsory social-security contributions	(5,555)	(8,398)
Expenses for pensions and other employee benefits	(903)	(550)
	(38,721)	(51,432)
<b>Total</b>	<b>(38,721)</b>	<b>(51,432)</b>

*Breakdown of expenses for pensions and other employee benefits*

	2002	2001
	( thousand)	
Costs of company pension scheme	(900)	(535)
Contributions to Versicherungsverein des Bankengewerbes a.G (BVV)	(3)	(15)
	(903)	(550)
<b>Total</b>	<b>(903)</b>	<b>(550)</b>

*Other administrative expenses*

	2002	2001
	( thousand)	
Marketing costs *)	(14,530)	(55,356)
Communication costs	(10,792)	(16,552)
Consulting costs	(8,956)	(12,510)
External services	(23,477)	(28,992)

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Sundry operating expenses	(18,402)	(30,769)
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>(76,157)</b>	<b>(144,179)</b>
	<u>          </u>	<u>          </u>

\*) In the previous year, the term read Costs of advertising, PR and representation

The expenses for operating lease contracts are considered as rental expenses and included in the sundry operating expenses.

*Depreciation of office furniture and equipment and intangible assets*

	<u>2002</u>	<u>2001</u>
	( thousand)	
Office furniture and equipment	(14,742)	(23,986)
Intangible assets	(8,518)	(4,720)
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>(23,260)</b>	<b>(28,706)</b>
	<u>          </u>	<u>          </u>

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**(26) Other operating result**

The Other operating result primarily comprises income from recoverable input taxes and income from the writing-back of provisions. Other details on taxes and tax consolidation can be found in Note 16.

	2002	2001
	( thousand)	
<b>Other operating expenses</b>	<b>(1,529)</b>	<b>(6,146)</b>
Payments to settle customers' complaints/provisions for process risks in direct brokerage business	(462)	(2,305)
Depreciation of goodwill	0	(2,043)
Losses on the disposal of property, plant and equipment	(455)	(114)
Sundry expense items	(612)	(1,684)
<b>Other operating income</b>	<b>4,446</b>	<b>12,805</b>
Income from recoverable input taxes	1,361	2,630
Income from the writing-back of provisions and accruals	1,228	1,465
Gains on the disposal of non-current assets	498	8
Income from tax consolidation	0	4,153
Sundry expense items	1,359	4,549
<b>Total</b>	<b>2,917</b>	<b>6,659</b>

**(27) Extraordinary result and restructuring costs**

comdirect's extraordinary result and restructuring costs mainly comprise the following expenses and income:

	2002	2001
	( thousand)	
<b>Extraordinary expenses</b>	<b>(37,431)</b>	<b>(98,340)</b>
extraordinary depreciation of goodwill	0	(25,924)
extraordinary depreciation of book value of investments	0	(10,500)
extraordinary depreciation on intangible and fixed assets	(5,545)	(21,196)
Restructuring costs (especially personnel costs and expenses arising from current contracts)	(31,883)	(21,575)
Costs of disposal/liquidation	0	(17,398)
Sundry expenses	(3)	(1,747)
<b>Extraordinary income</b>	<b>14,136</b>	<b>76</b>
Proceeds from disposal	0	76
Income from the restructuring of comdirect S.A., Paris and comdirect bank S.p.a. i. L., Milan	14,136	0
<b>Total</b>	<b>(23,295)</b>	<b>(98,264)</b>

(28) Taxes on income

	<u>2002</u>	<u>2001</u>
	( thousand)	
Current taxes on income	102	(906)
Deferred taxes	<u>(8,938)</u>	<u>10,983</u>
<b>Total</b>	<b><u>(8,836)</u></b>	<b><u>10,077</u></b>

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

*Transitional presentation of taxes on income*

	2002
	( thousand)
<b>Profit from ordinary activities</b>	<b>4,695</b>
multiplied by the German income-tax rate of 36.93%	
= Recalculated income-tax expenses financial year	1,734
+ Effects of different tax rates on current income taxes and deferred taxes	813
- Effects due to extraordinary results	11,821
+ Other causes	438
	(8,836)
<b>Total</b>	<b>(8,836)</b>

**(29) Cash reserve**

Cash reserve breaks down as follows:

	31.12.2002	31.12.2001
	( thousand)	
Cash on hand	123	232
Balances held at central banks	5,058	71,773
	5,181	72,005
<b>Total</b>	<b>5,181</b>	<b>72,005</b>

The minimum reserve requirement to be met at the end of December 2002 totalled 38,257 thousand (2001: 44,756 thousand).

**(30) Claims on banks**

	Total		Due on demand		Other claims	
	31.12.2002	31.12.2001	31.12.2002	31.12.2001	31.12.2002	31.12.2001
	( thousand)					
German banks	1,192,167	1,600,166	657,867	1,098,541	534,300	501,625
Foreign banks	102,252	83,946	95,746	46,446	6,506	37,500
	1,294,419	1,684,112	753,613	1,144,987	540,806	539,125
<b>Total</b>	<b>1,294,419</b>	<b>1,684,112</b>	<b>753,613</b>	<b>1,144,987</b>	<b>540,806</b>	<b>539,125</b>

Claims on banks include foreign-currency amounts equal to 95,746 thousand (2001: 39,310 thousand).



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Claims on banks primarily consist of overnight money and fixed deposits ( 1,293,095 thousand/2001: 1,634,874 thousand, incl. occurred interest ).

**(31) Claims on customers**

	<b>Total</b>		<b>Due on demand</b>		<b>Other claims</b>	
	<b>31.12.2002</b>	<b>31.12.2001</b>	<b>31.12.2002</b>	<b>31.12.2001</b>	<b>31.12.2002</b>	<b>31.12.2001</b>
( thousand )						
<b>Claims on domestic customers</b>	<b>172,644</b>	<b>261,293</b>	<b>172,644</b>	<b>261,293</b>	<b>0</b>	<b>0</b>
Public-sector entities	0	0	0	0	0	0
Private customers	172,644	261,293	172,644	261,293	0	0
<b>Claims on foreign customers</b>	<b>2,777</b>	<b>2,435</b>	<b>2,777</b>	<b>2,435</b>	<b>0</b>	<b>0</b>
Private customers	2,777	2,435	2,777	2,435	0	0
<b>Total</b>	<b>175,421</b>	<b>263,728</b>	<b>175,421</b>	<b>263,728</b>	<b>0</b>	<b>0</b>

All claims on private customers are deemed to be due on demand. Claims on customers include 163,185 thousand (2001: 250,603 thousand) from loans to finance purchases of securities. These claims are loans secured by securities. In view of the concentration of credit risks, we point out that the original loan business is carried out with private customers only. Claims on customers include foreign-currency amounts equal to 196 thousand (2001: 75 thousand).

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**(32) Provision for possible loan losses**

	Credit default risks		General provisions		Total	
	31.12.2002	31.12.2001	31.12.2002	31.12.2001	31.12.2002	31.12.2001
	( thousand)					
Balance as of 1 January	(4,905)	(3,149)	(31)	(31)	(4,936)	(3,180)
Allocations	(3,467)	(4,215)	(18)	0	(3,485)	(4,215)
Deductions	2,066	2,459	0	0	2,066	2,459
of which utilised	510	103	0	0	510	103
of which written back	1,556	2,356	0	0	1,556	2,356
Exchange-rate changes	0	0	0	0	0	0
	(6,306)	(4,905)	(49)	(31)	(6,355)	(4,936)
<b>Provision for possible loan losses as of 31 December</b>	<b>(6,306)</b>	<b>(4,905)</b>	<b>(49)</b>	<b>(31)</b>	<b>(6,355)</b>	<b>(4,936)</b>

The adjusted value of non-interest bearing and non-productive claims amounts to 4,339 thousand (2001: 4,943 thousand).

comdirect made a direct write-down of 118 thousand (2001: 222 thousand) and recorded receipts on written-down claims in an amount of 10 thousand (2001: 7 thousand).

The total balance of risk provisions for credit default risks breaks down as:

	31.12.2002	31.12.2001
	( thousand)	
German borrowers	(6,236)	(4,831)
Foreign borrowers	(70)	(74)
	(6,306)	(4,905)
<b>Total</b>	<b>(6,306)</b>	<b>(4,905)</b>

**(33) Trading assets**

Under this item, financial instruments acquired as part of the small trading portfolio are shown at fair value. Derivative financial instruments assigned to trading are shown with positive fair value including interest for the respective period.

	31.12.2002	31.12.2001
	( thousand)	
<b>Shares and other non-fixed interest securities</b>	<b>0</b>	<b>1,226</b>
Shares	0	0
German shares	0	0
Foreign shares	0	0

Other non-fixed interest securities	0	1,226
<b>Positive market value attributable to derivate financial instruments</b>	<b>0</b>	<b>938</b>
Interest-rate derivatives	0	938
	—	—
<b>Total</b>	<b>0</b>	<b>2,164</b>
	—	—

There were no restrictions on the disposal of any of the trading assets as of the balance-sheet date.

**(34) Financial investments**

All the financial instruments shown under Financial investments are assigned to the available for sale category and are measured at fair value. Excepted from this are holdings in subsidiaries and investments, which are shown at book value under Extraordinary appreciation and depreciation charges.

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

	31.12.2002	31.12.2001
( thousand)		
Bonds and other fixed-income securities of the available for sale portfolio	1,012,377	840,719
Bonds and notes	1,012,377	840,719
issued by public-sector borrowers	24,031	0
issued by other borrowers	988,346	840,719
Shares and other non-fixed interest securities of the available for sale portfolio	31,658	20,493
Investments	866	0
Holdings in subsidiaries	12,800	0
<b>Total</b>	<b>1,057,701</b>	<b>861,212</b>

There were no restrictions on the disposal of any of the financial assets as of the balance-sheet date.

On the balance-sheet date, no write-downs were made due to permanent impairment on financial instruments measured at fair value. In the financial year, the book value of the comdirect bank S.p.A. which is currently in liquidation was written up to the anticipated amount of the liquidation payout. The write-up in the amount of 6,426 thousand is part of the Extraordinary result.

In the item Investments, only the investment in Bremer Wertpapierbörse AG, which was renamed to Nasdaq Deutschland AG in January 2003, in the amount of 7.5 percent is shown.

**(35) Intangible assets**

	31.12.2002	31.12.2001
( thousand)		
Other intangible assets	14,094	22,076

Changes in intangible assets are shown in the schedule of assets (note 37).

**(36) Fixed assets**

	31.12.2002	31.12.2001
( thousand)		
Land and buildings	3,309	0
Office and furniture equipment	24,866	45,816
<b>Total</b>	<b>28,175</b>	<b>45,816</b>

Changes in fixed assets are shown in the schedule of assets (note 37).

## (37) Schedule of assets

	Land and buildings	Office furniture and equipment	
		Software	Other
		( thousand)	
<b>Book value as of 1 January, 2002</b>	<b>0</b>	<b>5,637</b>	<b>40,179</b>
Costs of acquisition/manufacture	0	21,198	98,344
Exchange-rate changes	0	0	(434)
Additions 2002	3,309	324	2,523
Disposals 2002	0	(6,368)	(42,171)
Costs of acquisition/manufacture as of 31 December, 2002	3,309	15,154	58,262
Cumulative write-downs as of 1 January, 2002	0	15,561	58,165
Exchange-rate changes	0	0	(92)
Additions 2002	0	2,352	12,390
Disposals 2002	0	(6,307)	(33,519)
Cumulative write-downs as of 31 December, 2002	0	11,606	36,944
<b>Book value as of 31 December, 2002</b>	<b>3,309</b>	<b>3,548</b>	<b>21,318</b>

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

	Intangible assets	Investments	Holdings in subsidiaries
	( thousand)		
<b>Book value as of 1 January, 2002</b>	<b>22,079</b>	<b>0</b>	<b>0</b>
Costs of acquisition/manufacture	33,739	10,500	0
Exchange-rate changes	(199)	0	0
Additions 2002	6,255	866	12,800
Disposals 2002	0	0	0
Costs of acquisition/manufacture as of 31 December, 2002	39,795	11,366	12,800
Cumulative write-downs as of 1 January, 2002	11,663	10,500	0
Exchange-rate changes	(25)	0	0
Additions 2002	14,063	0	0
Disposals 2002	0	0	0
Cumulative write-downs as of 31 December, 2002	25,701	10,500	0
<b>Book value as of 31 December 2002</b>	<b>14,094</b>	<b>866</b>	<b>12,800</b>

Additions to write-downs in 2002 relate to extraordinary write-downs of 5,545 thousand. This is included solely in the balance-sheet item Intangible assets.

**(38) Tax assets**

Tax assets breaks down as follows:

	31.12.2002	31.12.2001
	( thousand)	
Claims on the tax authorities from income taxes	8,512	9,634
Deferred tax claims	3,189	0
<b>Total</b>	<b>11,701</b>	<b>9,634</b>

Deferred tax claims and liabilities are netted out in Germany, since they are both due to the same tax authority. As a result, we show a deferred tax claim in the financial year 2002 (see also note 43).

Deferred tax claims were created in connection with the following balance-sheet items:

	31.12.2002	31.12.2001
	( thousand)	
Provision for possible loan losses	1	0
Financial investments	(2,361)	0
Intangible assets	(4,796)	0
Fixed assets	162	0
Provisions	3,617	0
Equity	6,566	0

	<u>          </u>	<u>          </u>
<b>Total</b>	<b>3,189</b>	<b>0</b>
	<b>—————</b>	<b>—————</b>

The domestic income-tax rate used to compute deferred taxes is composed of the applicable tax rates effective in Germany for corporate income tax (25.0%), plus the solidarity surcharge (5.5%) and the trade tax (12.7%) taken together. This yields a domestic income-tax rate of 35.7%.

**(39) Other assets**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	( thousand)	
Deferred items	3,111	5,693
Sundry assets	5,825	12,507
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>8,936</b>	<b>18,200</b>
	<b>—————</b>	<b>—————</b>

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

Other assets breaks down as follows:

	31.12.2002	31.12.2001
	( thousand)	
Claims on Group companies	4,709	8,494
Claims on affiliated companies	9	0
Other	1,107	4,013
<b>Total</b>	<b>5,825</b>	<b>12,507</b>

**(40) Liabilities to banks**

	Total		Due on demand		Other liabilities	
	31.12.2002	31.12.2001	31.12.2002	31.12.2001	31.12.2002	31.12.2001
	( thousand)					
German banks	1,926	0	1,926	0	0	0
Foreign banks	12,987	0	12,987	0	0	0
<b>Total</b>	<b>14,913</b>	<b>0</b>	<b>14,913</b>	<b>0</b>	<b>0</b>	<b>0</b>

**(41) Liabilities to customers**

	Total		Due on demand		With agreed maturity or withdrawal period	
	31.12.2002	31.12.2001	31.12.2002	31.12.2001	31.12.2002	31.12.2001
	( thousand)					
Liabilities to domestic private customers	1,822,191	2,196,023	1,749,450	2,150,113	72,741	45,910
Liabilities to foreign private customers	126,489	93,304	123,982	92,433	2,507	871
<b>Total</b>	<b>1,948,680</b>	<b>2,289,327</b>	<b>1,873,432</b>	<b>2,242,546</b>	<b>75,248</b>	<b>46,781</b>

Foreign-currency amounts equal to 85,067 thousand (2001: 28,846 thousand).

Through the German banks depositor protection fund of the German banking association Bundesverband deutscher Banken e. V., Cologne, each customer is insured for deposits of up to 171m. In addition, comdirect bank AG is a member of Entschädigungseinrichtung deutscher Banken GmbH.



**(42) Provisions**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	( thousand)	
Provisions for pensions and similar commitments	2,470	1,775
Other provisions	18,638	49,576
<b>Total</b>	<b>21,108</b>	<b>51,351</b>

The changes in provisions for pensions developed as follows:

	<u>as of 1.1.2002</u>	<u>Utilised/ change</u>	<u>Depreciation</u>	<u>Allocation</u>	<u>as of 31.12.2002</u>
	( thousand)				
Pension expectations of active employees	1,775	0	0	695	2,470

The allocations to pension provisions in 2002 break down as follows:

	( thousand)
Service cost	584
Interest cost	112
Cost arising from changes in actuarial assumptions	(1)

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**Table of Contents****COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

Actuarial gains and losses are amortised over three years (2002: 2 thousand).

Parameters	31.12.2002	31.12.2001	31.12.2000
Calculatory interest rate	5.75%	5.75%	6.50%
Changes in salaries	2.75%	3.00%	3.50%
Changes in pensions	1.50%	1.50%	2.00%

Changes in other provisions:

	as of 1.1.2002	Utilised	Reversal	Allocation	as of 31.12.2002
	( thousand)				
Provisions for staff	2,229	1,985	95	2,604	2,753
Provisions for anniversary bonuses	41	0	1	0	40
Provisions for non-income-related taxes	1,022	480	0	0	542
Provisions for contingent losses	18,336	8,811	7,681	6,318	8,162
Provisions for restructuring	26,602	26,517	9	6,379	6,455
Other provisions	1,346	913	172	425	686
<b>Total</b>	<b>49,576</b>	<b>38,706</b>	<b>7,958</b>	<b>15,726</b>	<b>18,638</b>

Provisions for staff mainly relate to provisions for bonuses. The provisions for staff will probably be used in the 2003 financial year.

Changes in provisions for contingent losses break down as follows:

	as of 1.1.2002	Utilised	Reversal	Allocation	as of 31.12.2002
	( thousand)				
<b>Provisions for contingent losses</b>	<b>18,336</b>	<b>8,811</b>	<b>7,681</b>	<b>6,318</b>	<b>8,162</b>
Implementation of the com one programme for the future	0	0	0	6,318	6,318
Restructuring	13,992	4,804	7,681	0	1,507
Other	4,344	4,007	0	0	337

The scale of the contingent losses for the implementation of the com one programme for the future were measured on the basis of the information about expected expenses that was available when the financial statements were prepared.

**(43) Tax liabilities**

Tax liabilities are comprised as follows:

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	31.12.2002	31.12.2001
	<u>          </u>	<u>          </u>
	( thousand)	
<b>Current tax liabilities</b>	<b>0</b>	<b>5,683</b>
Provisions for income taxes	0	5,683
<b>Deferred tax liabilities</b>	<b>0</b>	<b>4,761</b>
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>0</b>	<b>10,444</b>
	<u>          </u>	<u>          </u>

Deferred tax assets and liabilities are netted out in Germany, since they are both due to the same tax authority. As a result, we show a deferred tax asset in the financial year 2002 (see also note 38).

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

Deferred tax liabilities were created in connection with the following balance-sheets items:

	<u>31.12.2002</u>	<u>31.12.2001</u>
	( thousand)	
Provision for possible loan losses	0	23
Trading assets	0	347
Financial investments	0	2,300
Intangible assets	0	7,575
Fixed assets	0	(68)
Provisions	0	(2,226)
Equity	0	(3,190)
	<u>—</u>	<u>—</u>
<b>Total</b>	<b>0</b>	<b>4,761</b>
	<b>—</b>	<b>—</b>

**(44) Subordinated capital**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	( thousand)	
Subordinated liabilities	6,391	6,391
Profit-sharing certificates outstanding	10,226	10,226
	<u>—</u>	<u>—</u>
<b>Total</b>	<b>16,617</b>	<b>16,617</b>
	<b>—</b>	<b>—</b>

The subordinated capital meets the requirements of supplementary capital as defined by Art. 10, (5a) of the German Banking Act (KWG). The claims of creditors to repayment of these liabilities are subordinated to those of other creditors.

Terms of subordinated liabilities:

<u>Start of maturity</u>	<u>Amount thousand</u>	<u>Interest rate per 31.12.2002</u>	<u>Maturity date</u>
1996	6,391	3.06%	2006

The interest rate on subordinated liabilities was fixed for the first three years of the term to maturity. Currently, the interest rate is adjusted annually for a one-year interest-rate period.

During the financial year, comdirect incurred interest expenses on subordinated liabilities of 227 thousand (2001: 317 thousand).

Interest from profit-sharing certificates outstanding is paid only insofar as such payments do not lead to an accounting loss. The claims of the holders of the profit-sharing certificates are subordinated to the claims of other creditors.

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Terms of the profit-sharing certificates outstanding:

<u>Start of maturity</u>	<u>Amount thousand</u>	<u>Interest rate per 31.12.2002</u>	<u>Maturity date</u>
1998	10,226	6.00%	2006

During the financial year, comdirect incurred interest expenses on profit-sharing certificates of 613 thousand (2001: 733 thousand). As a net loss is shown, the interest payment for the current profit-sharing right will not be made.

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**(45) Maturities, by remaining lifetimes**

Remaining lifetimes as of 31.12.2002

	Total	Due on demand and unlimited in time	Up to three months	Three months to one year	One to five years	More than five years
( thousand)						
Claims on banks	1,294,419	753,613	207,147	211,220	122,439	0
Claims on customers	175,421	175,421	0	0	0	0
Bonds and notes held in the available for sale portfolio	1,012,377	0	127,563	188,317	584,148	112,349
<b>Total</b>	<b>2,482,217</b>	<b>929,034</b>	<b>334,710</b>	<b>399,537</b>	<b>706,587</b>	<b>112,349</b>
Liabilities to banks	14,913	14,913	0	0	0	0
Liabilities to customers	1,948,680	1,873,432	35,857	36,503	2,888	0
Subordinated capital	16,617	0	0	0	16,617	0
<b>Total</b>	<b>1,980,210</b>	<b>1,888,345</b>	<b>35,857</b>	<b>36,503</b>	<b>19,505</b>	<b>0</b>

Remaining lifetimes as of 31.12.2001

	Total	Due on demand and unlimited in time	Up to three months	Three months to one year	One to five years	More than five years
( thousand)						
Claims on banks	1,684,112	1,144,987	339,125	50,000	150,000	0
Claims on customers	263,728	263,728	0	0	0	0
Bonds and notes held in the available for sale portfolio	840,719	20,873	51,362	163,860	501,083	103,541
<b>Total</b>	<b>2,788,559</b>	<b>1,429,588</b>	<b>390,487</b>	<b>213,860</b>	<b>651,083</b>	<b>103,541</b>
Liabilities to banks	0	0	0	0	0	0
Liabilities to customers	2,289,327	2,242,546	20,052	24,844	1,885	0
Subordinated capital	16,617	0	0	0	16,617	0
<b>Total</b>	<b>2,305,944</b>	<b>2,242,546</b>	<b>20,052</b>	<b>24,844</b>	<b>18,502</b>	<b>0</b>

**(46) Claims on/liabilities to affiliated companies**

	31.12.2002	31.12.2001
	( thousand)	
Claims on banks	341,463	754,471
Liabilities to banks	14,913	0
Liabilities to customers	0	0
Subordinated capital	16,617	16,617
<b>Total</b>	<b>372,993</b>	<b>771,088</b>

**(47) Interest-rate risks**

	Interest assets		Interest liabilities		Interest gap	Interest differential
	million	interest in %	million	interest in %	million	% points
Up to one year	2,021	3.69	2,010	1.27	11	2.42
One to five years	361	4.27	434	3.31	(73)	0.96
More than five years	17	4.92	0	0.00	17	4.92

	GBP		GBP		GBP	% points
	million	interest in %	million	interest in %	million	% points
Up to one year	7	3.80	0	0.00	7	3.80

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**(48) Number of employees at the end of the reporting period**

	31.12.2002	31.12.2001
Group	922	1,291
in Germany	859	1,117
abroad	63	174
<b>At comdirect bank AG</b>	<b>859</b>	<b>1,117</b>
of which:		
in the call centre	366	517
in the back office	225	317
in other areas	268	283

**(49) Segment reporting**

Segment reporting, by geographical markets in the 2002 financial year:

	comdirect Germany	comdirect Europe, excluding Germany	Group management/ others/ consolidation	comdirect bank group total
( thousand)				
Net interest income before provisions	63,639	1,760	(1,503)	63,896
Provision for possible loan losses	(2,037)	0	0	(2,037)
Net interest income after provisions	61,602	1,760	(1,503)	61,859
Net commission income	73,828	3,314	0	77,142
Trading profit/loss	(285)	0	0	(285)
Result from the securities portfolio (available for sale)	1,200	0	0	1,200
Administrative expenses	122,128	16,010	0	138,138
Other operating result	2,949	(32)	0	2,917
<b>Profit/loss from ordinary activities</b>	<b>17,166</b>	<b>(10,968)</b>	<b>(1,503)</b>	<b>4,695</b>
Extraordinary results and restructuring costs	(48,830)	0	25,535	(23,295)
<b>Pre-tax profit/loss</b>	<b>(31,664)</b>	<b>(10,968)</b>	<b>24,032</b>	<b>(18,600)</b>
Taxes on income	(8,836)	0	0	(8,836)
<b>After-tax profit/loss</b>	<b>(22,828)</b>	<b>(10,968)</b>	<b>24,032</b>	<b>(9,764)</b>
Profit/loss attributable to minority interests	0	0	0	0
<b>Net profit/loss</b>	<b>(22,828)</b>	<b>(10,968)</b>	<b>24,032</b>	<b>(9,764)</b>
Acquisition costs of segment assets	7,313	1,789	0	9,102
Depreciation on segment assets	20,991	2,269	0	23,260
Cost-income-ratio	0.8715	3.1753		0.9615
<b>Segment income</b>	<b>177,972</b>	<b>5,936</b>	<b>(1,503)</b>	<b>182,405</b>
<b>Segment expenses</b>	<b>162,006</b>	<b>16,904</b>	<b>0</b>	<b>178,910</b>
<b>Segment assets</b>	<b>2,430,426</b>	<b>95,941</b>	<b>0</b>	<b>2,526,367</b>
<b>Segment debt</b>	<b>1,878,527</b>	<b>85,066</b>	<b>0</b>	<b>1,963,593</b>

Allocation to the segments is based on the domicile of the consolidated companies.

**(50) Other liabilities**



Rental and leasing agreements concluded by comdirect bank Group will lead to expenses of 6,326 thousand during 2003 financial year, 5,122 thousand for each of the years 2004 to 2007, and 6,336 thousand as of the year 2008.

**(51) Letter of comfort**

comdirect bank AG provides no general letter of comfort for the subsidiaries included in the consolidated financial statements.

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**COMDIRECT BANK GROUP  
NOTES (UNAUDITED) (Continued)**

**(52) Corporate Governance Code**

comdirect bank AG submitted the Declaration of Compliance pursuant to Art. 161 of the German Stock Corporation Act (AktG) and has made it permanently available to the shareholders at the website [www.comdirect.de](http://www.comdirect.de).

**(53) The company's boards**

***Supervisory board***

**Martin Blessing** (since 10 May, 2002)

Frankfurt am Main  
Chairman of the Supervisory Board  
Member of the Board of Managing Directors of  
Commerzbank AG, Frankfurt am Main

**Klaus-Peter Müller** (until 10 May, 2002)

Frankfurt am Main  
Chairman of the Supervisory Board  
Chairman of the Board of Managing Directors of  
Commerzbank AG, Frankfurt am Main

**Klaus Müller-Gebel**

Frankfurt am Main  
Deputy Chairman of the Supervisory Board  
Member of the Supervisory Board of  
Commerzbank AG, Frankfurt am Main

**Dr. Eric Strutz** (since 10 May, 2002)

Frankfurt am Main  
Head of Corporate Controlling of  
Commerzbank AG, Frankfurt am Main

**Dr. Franz-Georg Brune** (until 10 May, 2002)

Frankfurt am Main  
Co-manager of Frankfurt am Main main branch of  
Commerzbank AG, Frankfurt am Main

**Rainer Beaujean** (since 8 October, 2002)

Darmstadt  
Member of the Board of Managing Directors of  
T-Online International AG, Darmstadt

**Burkhard Graßmann** (until 1 October, 2002)

Darmstadt  
Member of the Board of Managing Directors of  
T-Online International AG, Darmstadt

**Angelika Kierstein**

Quickborn  
Chairman of Staff Council of  
comdirect bank Aktiengesellschaft  
Commercial employee

**Maria Xiromeriti**

Quickborn  
Deputy Chairman of Staff Council of  
comdirect bank Aktiengesellschaft  
Commercial employee

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**Board of Managing Directors****Dr. Achim Kassow,**

Chairman (since 1 June, 2002)

**Dr. Andre Carls****Hans-Joachim Nitschke****Bernt Weber** (until 31 May, 2002)**Christian Jessen** (until 30 June, 2002)**(54) Shares of comdirect bank AG**

Number of shares held by the boards:

	<u>31.12.2002</u>	<u>31.12.2001</u>
<b>Members of the Board of Managing Directors</b>	<b>0</b>	<b>700</b>
Dr. Achim Kassow (since 1 June, 2002)	0	
Dr. Andre Carls	0	0
Christian Jessen (until 30 June, 2002)		200
Hans-Joachim Nitschke	0	0
Bernt Weber (until 31 May, 2002)		500
<b>Members of the Supervisory Boards</b>	<b>150</b>	<b>150</b>
Martin Blessing (since 10 May, 2002)	0	
Klaus-Peter Müller (until 10 May, 2002)		0
Klaus Müller-Gebel	0	0
Dr. Eric Strutz (since 10 May, 2002)	0	
Dr. Franz-Georg Brune (until 10 May, 2002)		0
Rainer Beaujean (since 8 October, 2002)	0	
Burkhard Graßmann (until 1 October, 2002)		0
Angelika Kierstein	100	100
Maria Xiromeriti	50	50

The number of options held to subscribe to comdirect bank AG shares breaks down as follows:

	<u>31.12.2002</u>	<u>31.12.2001</u>
<b>Members of the Board of Managing Directors</b>	<b>129,000</b>	<b>90,000</b>
Dr. Achim Kassow (since 1 June, 2002)	40,000	
Dr. Andre Carls	38,500	13,500
Christian Jessen (until 30 June, 2002)		25,500
Hans-Joachim Nitschke	50,500	25,500
Bernt Weber (until 31 May, 2002)		25,500
<b>Members of the Supervisory Boards</b>	<b>0</b>	<b>0</b>
Martin Blessing (since 10 May, 2002)	0	
Klaus-Peter Müller (until 10 May, 2002)		0
Klaus Müller-Gebel	0	0
Dr. Eric Strutz (since 10 May, 2002)	0	
Dr. Franz-Georg Brune (until 10 May, 2002)		0
Rainer Beaujean (since 8 October, 2002)	0	
Burkhard Graßmann (until 1 October, 2002)		0
Angelika Kierstein	0	0

Maria Xiromeriti

0

0

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**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) (Continued)**

**(55) Remuneration and loans to board members**

The following remuneration was paid to members of the Board of Managing Directors and members of the Supervisory Boards:

	<u>2002</u>	<u>2001</u>
	( thousand)	
Board of Managing Directors	961	1,290
of which: non-variable	700	794
of which: variable	261	496
Supervisory Boards	23	87

Neither advance payments nor loans were extended. comdirect did not take on any contingent liabilities.

**Holdings**

<u>Name</u>	<u>Domicile</u>	<u>Share of capital held in %</u>	<u>Equity in thousand</u>	
comdirect ltd	London/ United Kingdom	100.0	GBP	9,857
comdirect nominee ltd	London/ United Kingdom	100.0	GBP	(1.00)
comdirect bank S.p.A. i.L.	Milan/ Italy	100.0	EUR	12,800

Quickborn, 14 February, 2003

The Board of Managing Directors

Dr. Achim Kassow

Dr. Andre Carls

Hans-Joachim Nitschke

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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**For the years ended 31 December 2001 and 2000**

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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**AS OF DECEMBER 31, 2001 AND 2000**

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**Table of Contents****CONSOLIDATED INCOME STATEMENTS OF****COMDIRECT BANK GROUP  
ACCORDING TO IAS (UNAUDITED)**

	Notes	1.1.-31.12.2001	1.1.-31.12.2000
		( thousand) (unaudited)	( thousand) (unaudited)
<b>INCOME STATEMENT</b>			
Interest income		138,621	121,046
Interest expenses		64,538	63,329
Net interest income before provisions	(23)	74,083	57,717
Provision for possible loan losses	(24)	(2,074)	(1,966)
Net interest income after provisions		72,009	55,751
Commission income		96,957	192,656
Commission expenses		3,939	1,793
Net commission income	(25)	93,018	190,863
Trading profit	(26)	(29)	(133)
Result from financial investments		344	0
Administrative expenses	(27)	224,317	220,951
Other operating result	(28)	6,659	35
<b>Profit from ordinary activities</b>		<b>(52,316)</b>	<b>25,565</b>
Extraordinary result and restructuring expenses	(29)	(98,264)	0
<b>Pre-tax profit</b>		<b>(150,580)</b>	<b>25,565</b>
Taxes on income	(30)	10,077	23,371
<b>After-tax profit</b>		<b>(160,657)</b>	<b>2,194</b>
Profit/loss attributable to minority interests		0	484
<b>Net profit/loss for the year</b>		<b>(160,657)</b>	<b>2,678</b>
Transfer from reserves		160,657	0
<b>Consolidated profit/loss</b>		<b>0</b>	<b>2,678</b>

**EARNINGS PER SHARE**

		1.1.-31.12.2001	1.1.-31.12.2000
<b>BASIC EARNINGS PER SHARE</b>			
Net income/loss for the year	( thousand)	(160,657)	2,678
Average number of ordinary shares	unit	140,500,000	104,959,016
<b>Basic earnings per share</b>		<b>(1.14)</b>	<b>0.03</b>

		<u>1.1.-31.12.2001</u>	<u>1.1.-31.12.2000</u>
<b>DILUTED EARNINGS PER SHARE</b>			
Net income/loss for the year	(		
	thousand)	(160,657)	2,678
Adjustment to the number of ordinary shares issued due to outstanding option rights	unit	97,278	32,660
Weighted average shares outstanding (diluted)	unit	140,597,278	104,991,677
		<u>                    </u>	<u>                    </u>
<b>Diluted earnings per share</b>		(1.14)	0.03
		<u>                    </u>	<u>                    </u>

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**Table of Contents****CONSOLIDATED BALANCE SHEETS OF****COMDIRECT BANK GROUP  
ACCORDING TO IAS (UNAUDITED)**

ASSETS	Notes	as of 31.12.2001	as of 31.12.2000
		( thousand) (unaudited)	( thousand) (unaudited)
Cash reserve	(31)	72,005	515
Claims on banks	(32)	1,684,112	1,006,477
Claims on customers	(33)	263,728	575,524
Provisions for possible loan losses	(34)	(4,936)	(3,180)
Trading assets	(35)	2,164	883
Financial investments	(36)	861,212	1,153,239
Intangible assets	(37)	22,076	40,950
Fixed assets	(38)	45,816	76,335
Tax assets		9,634	8,679
Other assets	(40)	18,200	15,683
<b>Total assets</b>		<b>2,974,011</b>	<b>2,875,105</b>

LIABILITIES AND EQUITY	Notes	as of 31.12.2001	as of 31.12.2000
		( thousand) (unaudited)	( thousand) (unaudited)
Liabilities to banks	(41)	0	3,678
Liabilities to customers	(42)	2,289,327	2,044,554
Provisions	(43)	51,351	5,728
Tax liabilities	(44)	10,444	10,794
Other liabilities		28,162	40,967
Subordinated capital	(45)	16,617	29,399
Minority interests		0	287
<b>Equity</b>		<b>578,110</b>	<b>739,698</b>
Subscribed capital		140,500	140,500
Capital reserve		394,327	595,834
Retained earnings			
Legal reserve		0	686
Other revenue reserves		42,200	0
Revaluation reserve		1,083	0
Consolidated profit/loss		0	2,678
<b>Total liabilities and equity</b>		<b>2,974,011</b>	<b>2,875,105</b>

**Table of Contents****STATEMENT OF CHANGES IN EQUITY****OF COMDIRECT BANK GROUP  
(UNAUDITED)**

	Subscribed capital	Capital reserve	Retained earnings	Revaluation reserve	Consolidated profit/loss	Total 2001	Total 2000
( thousand)							
<b>Equity as of 1.1 (unaudited)</b>	<b>140,500</b>	<b>595,834</b>	<b>686</b>	<b>0</b>	<b>2,678</b>	<b>739,698</b>	<b>62,817</b>
Reversal of the correction per 31.12.2000		3,875	0		(3,875)	0	0
Booking of valuation differences due to swap transactions pursuant to IAS 39			(2,646)		0	(2,646)	0
Formation of a revaluation reserve pursuant to IAS 39			0	1,083	0	1,083	0
Capital increases			0		0	0	695,500
Appropriation of consolidated loss			0		0	0	6,183
Consolidated profit/consolidated loss			0		(160,657)	(160,657)	2,678
Changes in differences arising from currency translation			632		0	632	0
Costs of IPO			0		0	0	(19,803)
Transfer from reserves/allocation to reserves		(205,382)	43,528		161,854	0	(7,677)
<b>Equity as of 31.12 (unaudited)</b>	<b>140,500</b>	<b>394,327</b>	<b>42,200</b>	<b>1,083</b>	<b>0</b>	<b>578,110</b>	<b>739,698</b>

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## CONSOLIDATED CASH FLOW STATEMENTS

OF COMDIRECT BANK GROUP  
(UNAUDITED)

	1 January - 31 December	
	2001	2000
	(in thousand) (unaudited)	
<b>Net profit/net loss</b>	<b>(160,657)</b>	<b>2,678</b>
Non-cash positions in net income and adjustments to reconcile net income to net cash provided by operating activities		
Write-downs, depreciations, adjustments and write-ups to fixed assets and changes in provisions	32,830	19,936
Loss/profit from the sale of financial investments and fixed assets	114	0
Other adjustments (net)	(16,798)	(20,384)
<b>Subtotal</b>	<b>(144,511)</b>	<b>2,230</b>
Change in assets and liabilities from operating activities after correction for non-cash components		
Claims		
on banks	(683,544)	211,425
on customers	311,497	(255,385)
Securities	284,171	(447,738)
Other assets from operating activities	55	(20,803)
Liabilities		
to banks	(3,678)	(18,363)
to customers	244,773	(107,639)
Other liabilities from operating activities	3,197	(5,248)
Interest and dividends received	143,612	111,601
Interest paid	(64,538)	(61,609)
Income tax paid	0	(4,104)
<b>Cash flow from operating activities</b>	<b>91,034</b>	<b>(595,633)</b>
<b>Change from investing activities (net)</b>	<b>(7,394)</b>	<b>(103,373)</b>
Proceeds from capital increases	0	655,885
Change from subordinated capital and other (net)	(12,782)	0
<b>Net cash provided by financing activities</b>	<b>(12,782)</b>	<b>655,885</b>
<b>Cash and cash equivalents at the end of the previous period</b>	<b>515</b>	<b>43,636</b>
Cash flow from operating activities	91,034	(595,633)
Cash flow from investing activities	(7,394)	(103,373)
Net cash provided by financing activities	(12,782)	655,885
Effects of changes in exchange rates	632	0
<b>Cash and cash equivalents at the end of the period</b>	<b>72,005</b>	<b>515</b>



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**COMDIRECT BANK GROUP**

**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED)**

**Accounting principles**

The consolidated financial statements of comdirect bank as of 31 December, 2001 were prepared in accordance with the International Accounting Standards (IAS) approved and published by the International Accounting Standards Committee (IAS) and with their interpretation by the Standing Interpretations Committee (SIC).

A summary of all the regulations that have been applied can be found on pages 55 and 56.<sup>(1)</sup>

As a subsidiary of Commerzbank AG, Frankfurt am Main, we are exempted in accordance with Art. 291, German Commercial Code (HGB), from the duty to present sub-group financial statements. As we have not presented the main differences between financial statements prepared in accordance with IAS and those prepared in accordance with the German Commercial Code, these consolidated financial statements do not conform to the 4th and 7th EC directives and do not, therefore, exempt us from presenting consolidated financial statements in accordance with Art. 292a, HGB. The consolidated financial statements have been prepared in order to satisfy the admission requirements of the Neuer Markt.

The consolidated financial statements also reflect the standards approved by German Accounting Standards Board (GASB) and published by the German Federal Ministry of Justice pursuant to Art. 342, (2), HGB.

The comdirect sub-group is included in the consolidated financial statements of our parent company. The consolidated financial statements of Commerzbank as of 31 December, 2000 were deposited with the lower regional court (Amtsgericht) of Frankfurt am Main under the commercial register no. 32000 and published in the Federal Gazette, no. 111, page 660977 of 20 June, 2001.

We report on both the implementation of the German legislation for control and transparency in the corporate sector (KonTraG) and on the risks posed by future development, pursuant to Art. 315, (1), HGB in the risk report.

In addition to the income statement and the balance sheet, the consolidated financial statements also include the statement of changes in equity, a cash flow statement and the notes. Segment reporting appears as part of the notes, on page 77.<sup>(2)</sup>

Unless otherwise indicated, all the amounts are shown in thousands of euros.

**Accounting and measurement methods**

**(1) Basic principles**

The consolidated financial statements of comdirect are based on the going concern principle.

For our subsidiaries in France (comdirect S.A., Paris/ France) and Italy (comdirect bank S.p.A., Milan/ Italy), no selling agreement had been signed or the liquidation of the company in question had not been completed by the day on which the balance sheet and income statement were prepared. In view of the decisions taken by the majority shareholder, we have not applied the going concern principle to these subsidiaries.

The principle of profit or loss for the period is applied in our consolidated financial statements. Income and expenses are recognised on a pro-rata basis; they are shown for the period to which they may be assigned in economic terms.

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As a matter of principle, accounting is at net book value, with the exception of financial instruments as defined by IAS 39, which are shown at their fair value. These financial instruments appear under the items Trading assets and Financial investments.

All the companies included in the consolidation prepared their financial statements as of 31 December 2001.

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- (1) For the purposes of this filing, please refer to page A-136.
  - (2) For the purposes of this filing, please refer to page A-153.
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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(2) IAS, SIC and GASB rules applied**

Within the comdirect Group and within the Commerzbank Group, to which it belongs, only those IASs and SICs are applied for accounting and measurement purposes which had been approved and published by 31 December, 2001.

The interpretation of the standard with regard to Consolidation Special purpose entities (SIC-12) was not applied, as no holdings existed on the balance-sheet date.

The follow list provides a summary of the International Accounting Standards (IASs) applied in comdirect s 2001 consolidated financial statements.

IAS 1	Presentation of financial statements
IAS 7	Cash flow statements
IAS 8	Net profit or loss for the period, fundamental errors and changes in accounting policies
IAS 10	Events after the balance-sheet date
IAS 12	Income taxes
IAS 14	Segment reporting
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 21	The effects of changes in foreign-exchange rates
IAS 22	Business combinations
IAS 24	Related party disclosures
IAS 26	Accounting and reporting by retirement benefit plans
IAS 27	Consolidated financial statements and accounting for investments in subsidiaries
IAS 30	Disclosures in the financial statements of banks and similar financial institutions
IAS 32	Financial instruments: disclosure and presentation
IAS 33	Earnings per share
IAS 35	Discontinuing operations
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments: recognition and measurement

In addition, we provide a list below of the SIC interpretations relevant for us, which we have taken into consideration in our 2001 consolidated financial statements.

		relates to:
SIC-6	Costs of modifying existing software	Framework
SIC-7	Introduction of the euro	IAS 21
SIC-15	Operating leases incentives	IAS 17
SIC-17	Equity costs of an equity transaction	IAS 32
SIC-18	Consistency alternative methods	IAS 1

**(3) Consolidated companies**

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Apart from the parent company, the consolidated companies consist of three subsidiaries, so that altogether four companies were included in our consolidated financial statements. comdirect bank AG holds over 50% of the capital of each subsidiary directly. A detailed presentation of holdings appears on page 80.<sup>(3)</sup>

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(3) For the purposes of this filing, please refer to page A-156.

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**COMDIRECT BANK GROUP  
NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(4) Principles of consolidation**

The consolidation of the capital accounts is based on the book-value method, whereby the historical cost of the shares held by the parent company in each individual subsidiary and the share of each subsidiary's capital held by the parent company are set off against the proportion of the subsidiary's equity that was acquired.

On principle, any residual positive differences in amount are shown as goodwill under intangible assets in the balance sheet and depreciated to reflect their probable economic lives over a period of 15 years, using the straight-line method.

Ordinary amortisation of goodwill are included in other operating results and the extraordinary amortisation of goodwill are included in extraordinary result and restructuring expenses. We draw attention to the remarks on Intangible assets on page 69.<sup>(4)</sup>

Intra-group expenses and income, as well as claims and liabilities, are eliminated as part of the consolidation.

Minority shares in equity and profit or loss are shown separately as minority interests and as profit/loss attributable to minority interests.

As part of our efforts to sell comdirect S.A., Paris/ France, we purchased the shares held by outside shareholders as of January 2002, raising our interest in the company to 100%.

**(5) Changes in accounting and disclosure methods**

IAS 39 was applied at Group level for the first time for the 2001 financial year. As this standard may not be applied retrospectively all by itself, the year-ago figures have not been adjusted.

The quarterly reports published by comdirect in 2001 already incorporated aspects of IAS 39.

IAS 39 regulates how financial instruments are treated in the balance sheet, and especially their recognition and measurement.

All financial instruments, including all financial derivatives, are shown using the trade date accounting method.

Throughout the Group, all financial instruments are assigned exclusively either to the available for sale or trading categories.

The available for sale category includes all the bonds, other fixed-income securities and also equities and other variable-yield securities not held for trading purposes.

Securities from the trading portfolio and unsecured derivative financial instruments are assigned to the trading category.

As part of the first-time application of IAS 39, we have adjusted the opening balance sheet to recognise the valuation differences for derivative financial instruments due to the book value approach and the current values to be attributed, and to show these within equity under retained earnings, taking deferred taxes into account.

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Taking deferred taxes into account, we have recognised valuation differences arising from other financial instruments under equity in the item revaluation reserve. As of end-2001, the revaluation reserve amounted to 1,083 thousand.

As of 31 December, 2001, we measured all the financial instruments in the available for sale and trading categories at market prices in active markets.

The profits generated by the disposal or maturing of financial instruments assigned to the available for sale category amounted to altogether 350 thousand as of 31 December, 2001. The corresponding losses came to 6 thousand.

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(4) For the purposes of this filing, please refer to page A-147.

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

The interest income generated by the financial instruments assigned to the available for sale category amounted to 61,732 thousand at end-2001.

**(6) Currency translation**

The items from the income statement and also the assets and liabilities from the balance sheet which are denominated in foreign currencies are translated at the spot rates of the balance-sheet date.

Holdings in affiliated companies that are denominated in foreign currencies appear at historical cost.

comdirect nets translation gains and losses from the consolidation of the capital accounts against retained earnings.

The annual financial statements prepared by our subsidiaries in foreign currencies are translated at the spot rates of the balance-sheet date. Any income and expenses resulting from translation appear in the income statement.

The most important translation rates for the comdirect Group can be found in the table below:

Unit/1	31.12.2001	31.12.2000
	(unaudited)	(unaudited)
GBP	0.6085	0.6241
FRA	6.55957	6.55957
ITL	1,936.27	1,936.27

**(7) Claims**

All claims on banks and customers are shown at amortised cost without valuation allowances.

Valuation allowances to claims appear under provisions for possible loan losses.

On the balance-sheet date, we had no acquired claims, i.e. sections of a credit originated by another lender, in our portfolio.

**(8) Provisions for possible loan losses**

Valuation allowances, in the form of individual and lump-sum valuation allowances, are formed exclusively for claims on customers.

Throughout the Group, the relevant individual valuation allowances are formed on the scale of the potential default to cover credit-standing risks related to claims on customers.

We cover latent credit risks by means of lump-sum valuation allowances. Past loan losses serve as a yardstick for the scale on which such lump-sum valuation allowances have to be formed.

Unrecoverable accounts are written down immediately. Amounts received on such claims appear in the income statement. Claims are deemed unrecoverable if income from them is unlikely to be received in the foreseeable future or if they have been waived either wholly or in part.

**(9) Trading assets**

Securities acquired as part of the small trading portfolio and derivative financial instruments (swaps) appear under Assets held for dealing purposes.

On the balance-sheet date, only interest-rate swaps measured at fair value were included under this item.

Realised gains and losses from the purchase and sale of securities from the small trading portfolio are shown in the income statement under Trading profit.

Gains or losses registered upon remeasurement of the derivative financial instruments are also included in the Trading profit.

The Trading profit also reflects all the interest and dividend income arising from the trading portfolio.

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**COMDIRECT BANK GROUP  
NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(10) Financial investments**

Under Financial investments, we show all the securities which we have assigned to the available for sale category.

On the balance-sheet date, bonds and other fixed-income securities as well as investment fund units were assigned to the available for sale category.

All the securities of this category were measured at their fair value.

Gains or losses on remeasurement are recognised with an income-neutral effect in the form of a revaluation reserve as part of equity.

All the interest income generated by securities of the available for sale category is shown under Interest received.

**(11) Intangible assets**

Under Intangible assets, we include software produced in-house and Goodwill. Purchased software is shown under Fixed assets.

More details can be found under Changes in book value of fixed assets and investments (page 70,<sup>(5)</sup> note 39).

Software produced in-house is recognised if all the provisions of IAS 38 are met. Recognition is made at producer cost, reflecting only the costs that can be assigned directly to the specific project.

In principle software produced in-house is amortised against earnings over a period of five years.

The goodwill created by the acquisition of comdirect S.A. was examined on the balance-sheet date with regard to its future utility.

We have found that under existing conditions no future utility can be expected. As a result, we made an extraordinary write-down of 25,924 thousand in the year under review.

The extraordinary write-down is shown in the income statement under Extraordinary result and restructuring expenses.

**(12) Fixed assets**

Only office furniture and equipment and purchased software are included here.

All the fixed assets are capitalised at cost and depreciated using the straight-line method to reflect their probable useful economic lives.

In determining the useful life of an asset, its likely physical wear and tear, its technical obsolescence and also legal restrictions are taken into consideration. All fixed assets are de-preciated over a period of two to ten years.

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Gains and losses arising from the sale of fixed assets are shown in the income statement under Other operating result.

We made extraordinary depreciation on fixed assets in the year under review when the amount that could probably be achieved through future use had fallen below their book value.

### **(13) Other assets**

Other assets mainly consist of other assets on Commerzbank AG and deferred items.

### **(14) Liabilities**

Liabilities are shown at the respective amounts to be repaid.

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(5) For the purposes of this filing, please refer to page A-148.  
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**COMDIRECT BANK GROUP  
NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(15) Other liabilities**

Other liabilities consist primarily of trade liabilities, liabilities to Commerzbank AG not arising from banking activities, tax liabilities not related to earnings and accruals.

**(16) Provisions for pensions and similar commitments**

The pension commitments that are shown exist solely towards members of the Board of Managing Directors of comdirect bank AG. These are based on the length of service, the pensionable salary and the currently valid scales for employer subsidies.

In accordance with IAS 19, the projected-unit-credit method was used to calculate pension commitments.

Commitments are calculated on the basis of actuarial surveys. The calculation also takes into account the rates of increase for salaries and pensions that can be expected in the future.

If actuarial commitments prove to be higher or lower, these are recognised under Personnel costs.

**(17) Other provisions**

Other provisions were formed for liabilities of uncertain amount towards third parties.

In addition, we have formed provisions for contingent losses for existing adverse agreements, in which the expense required in order to fulfil the agreement is greater than the income generated by the agreement.

We formed the major provisions for contingent losses on account of restructuring measures, i.e. due to the sale or closure of our subsidiaries in France and Italy.

**(18) Taxes on income**

Tax expenses are shown under Taxes on income. A breakdown of this item into current and deferred taxes on income can be found in these notes on page 66<sup>(6)</sup>, note 30.

Deferred taxes were formed in accordance with IAS 12. Temporary differences are the result of the discrepancy between assigned values in accordance with IAS and the respective tax rate that was applied. These temporary differences are measured using the specific income-tax rates which apply in the country where the company in question has its seat and which can be expected to apply for the period in which they are realised. Deferred taxes on as yet unused losses carried forward are only shown for comdirect bank AG. Deferred taxes on losses carried forward formed in previous years have been released.

Deferred tax assets and liabilities are netted against one another in Germany, as they exist towards the same tax authority.

Claims on tax authorities are shown under Tax assets in the balance sheet.

Other taxes not related to income appear under Other operating result in the income statement.

When the profit-and-loss-transfer agreement was terminated on 31 December, 1999, it was assumed with the agreement of the tax authorities that, for accounting purposes, the integrated inter-company relationship between comdirect bank AG and Commerzbank AG had ceased to exist. In a final judgement, however, it was

decided that this relationship continued to exist as regards turnover and trade tax for the 2000 and 2001 assessment periods. As a result of the amendments to Germany's legislation on the further development of corporate taxation, the fiscal unity in terms of trade tax ended on 31 December, 2001; and was maintained only with regard to turnover tax as from 2002.

**(19) Conditional and authorised capital**

Through the resolution adopted on 10 April, 2000, and its entry into the commercial register on 19 April, 2000, authorised capital of 60,000 thousand was created. The authorisation for the capital increase expires on 31 March, 2005.

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(6) For the purposes of this filing, please refer to pages A-144 to A-145.  
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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

In addition, since the resolution adopted on the same date and entered into the commercial register on 31 May, 2000, conditional capital of 3,600 thousand was created in order to issue subscription rights as part of the bank's stock option scheme.

**(20) Transfer from reserves**

In connection with decisions relating to our subsidiaries in Italy and France in the 2001 financial year, we have transferred a net 160,657 thousand from reserves in order to cover the accumulated losses.

**(21) Earnings per share**

Earnings per share calculated in accordance with IAS 33 are based on the net profit/loss for the year. We show both the undiluted and the diluted earnings per share below the income statement.

In working out the undiluted result, we have set off the net profit/loss for the year against the average number of shares in the financial year.

The diluting effects result from a stock option scheme launched in July 2000 with a maximum of 3,600,000 subscription rights, 875,000 option rights of which had been issued in two tranches per 31 December, 2001.

In calculating the diluting effects, we set off the two sub-sets of rights under the stock option scheme with their conditions against well-founded estimated values for them and took account of the residual amount.

The nominal value per share is 1 euro.

**(22) Relations with affiliated companies**

comdirect uses services provided by Commerzbank AG through a general agreement concluded in December 1999 (and effective as from 1 January, 1999) and also services agreed separately on this basis.

The general agreement has a fixed term of five years and ends on 31 December, 2003. It is automatically extended for a further period of three years, unless one of the parties to the agreement gives notice at least 18 months before the agreement expires.

On the basis of the general agreement, the following services were agreed upon and were used during the 2001 financial year:

Trading services

Processing services

Payments and cash dispenser service

IT services

Other services

In February 2000, comdirect concluded another general agreement with Commerzbank, in which Commerzbank undertook to provide internal auditing services on the basis of a plan to be agreed separately. The agreement was concluded for an indefinite period and may be terminated giving six months' notice before the

end of the calendar year, but not before 31 December, 2002.

comdirect is party to an agreement of Commerzbank with Commerzbank Capital Markets, enabling comdirect to trade on US stock exchanges.

On 22 March, 2000, comdirect concluded an agreement with Commerzbank concerning support for comdirect after its IPO. Among other things, the agreement relates to support for PR activities, compliance with stock-exchange and other obligations resulting from admission to the stock exchange and advice on the holding of the first public annual general meeting of shareholders in 2001.

Commerzbank received compensation in line with market rates for the goods and services it provides for comdirect.

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**Table of Contents****COMDIRECT BANK GROUP****NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

When forming or purchasing subsidiaries, comdirect pledged directly or indirectly to ensure that they comply with the specific equity capital requirements of the country in question.

In this connection, comdirect allocated equity of 39,978 thousand to comdirect S.A., Paris/ France, in the 2001 financial year.

Over the same period, comdirect bank S.p.A, Milan/ Italy, was allocated 20,800 thousand.

comdirect ltd, London/ United Kingdom, received equity of 12,356 thousand in the 2001 financial year.

**(23) Net interest income**

	<b>2001</b>	<b>2000</b>
	( thousand) (unaudited)	
Interest and dividends from shares and other non-fixed interest securities held in the available for sale portfolio	18,589	4,876
Interest income from fixed-income securities held in the available for sale portfolio and from government-inscribed debt	43,143	35,485
Other interest income including discount surplus	76,889	80,685
Interest on participation rights and subordinate liabilities	(1,050)	(1,491)
Other interest expenses	(63,488)	(61,838)
<b>Total</b>	<b>74,083</b>	<b>57,717</b>

**(24) Provision for possible loan losses**

The provisions of the comdirect Group breaks down as follows:

	<b>2001</b>	<b>2000</b>
	( thousand) (unaudited)	
Allocations to provisions	(4,215)	(2,151)
Write-back of provisions	2,356	211
Direct write-downs	(222)	(37)
Income received on written-down claims	7	11
<b>Total</b>	<b>(2,074)</b>	<b>(1,966)</b>

**(25) Net commission income**

	<b>2001</b>	<b>2000</b>
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	( thousand) (unaudited)	
Securities transactions	89,316	189,172
Payment transactions	3,335	1,408
Other commissions	367	283
<b>Total</b>	<b>93,018</b>	<b>190,863</b>

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(26) Trading profit**

All the financial instruments assigned to the Assets held for dealing purposes are measured at fair value. The results arising from trading activities are included along with interest and dividend income, attributable to instruments shown under Assets held for dealing purposes, in the Trading profit.

	2001	2000
	( thousand) (unaudited)	
<b>Result of securities trading</b>	<b>(332)</b>	<b>(133)</b>
Result from trading in bonds and notes	9	0
Result from trading in shares and other non-fixed interest securities	(341)	(133)
<b>Other trading result</b>	<b>(726)</b>	<b>0</b>
Result from trading in interest-rate risks	(726)	0
<b>Valuation result</b>	<b>1,029</b>	<b>0</b>
Interest-rate derivatives	1,029	0
<b>Total</b>	<b>(29)</b>	<b>(133)</b>

**(27) Administrative expenses***Personnel expenses*

	2001	2000
	( thousand) (unaudited)	
Wages and salaries	(42,484)	(36,170)
Compulsory social-security contributions	(8,398)	(6,739)
Expenses for pensions and other employee benefits	(550)	(604)
<b>Total</b>	<b>(51,432)</b>	<b>(43,513)</b>

*Breakdown of expenses for pensions and other employee benefits*

	2001	2000
	( thousand) (unaudited)	
Costs of company pension scheme	(535)	(594)
Contributions to Versicherungsverein des Bankengewerbes a.G. (BVV)	(15)	(10)
<b>Total</b>	<b>(550)</b>	<b>(604)</b>

*General operating expenses*

	<u>2001</u>	<u>2000</u>
	( thousand) (unaudited)	
Costs of advertising, PR and representation	(55,356)	(59,148)
Communication expenses	(16,552)	(19,929)
Consulting expenses	(12,510)	(22,105)
External services	(28,992)	(38,675)
Other general operating expenses	(30,769)	(19,305)
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>(144,179)</b>	<b>(159,162)</b>
	<u>          </u>	<u>          </u>

The expenses for operating lease contracts are considered as rental expenses and included in the other general operating expenses.

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

*Depreciation of office furniture and equipment and intangible assets*

	2001	2000
	( thousand) (unaudited)	
Office furniture and equipment	(23,986)	(15,677)
Intangible assets	(4,720)	(2,599)
<b>Total</b>	<b>(28,706)</b>	<b>(18,276)</b>

**(28) Other operating result**

The Other operating result primarily comprises income from tax consolidations, income from recoverable input taxes and income from the writing-back of provisions. Other details on taxes and tax consolidation can be found in these notes on page 60 ff.<sup>(7)</sup>

	2001	2000
	( thousand) (unaudited)	
<b>Other operating expenses</b>	<b>(6,146)</b>	<b>(5,768)</b>
Payments to settle customers' complaints/ provisions for process risks in direct brokerage business	(2,305)	(3,288)
Depreciation of goodwill	(2,043)	(1,761)
Sundry expense items	(1,798)	(719)
<b>Other operating income</b>	<b>12,805</b>	<b>5,803</b>
Income from recoverable input taxes	2,630	3,810
Income from the writing-back of provisions and accruals	1,465	487
Income from tax consolidation	4,153	0
Sundry income items	4,557	1,506
<b>Total</b>	<b>6,659</b>	<b>35</b>

**(29) Extraordinary result and restructuring costs**

Due to restructuring decisions relating to our subsidiaries, the comdirect bank Group's extraordinary result and restructuring costs comprises the following expenses and income:

	2001	2000
	( thousand) (unaudited)	
<b>Extraordinary expenses</b>	<b>(98,340)</b>	<b>0</b>
extraordinary depreciation of goodwill	(25,924)	0
extraordinary depreciation on investments	(10,500)	0
extraordinary depreciation on intangible and fixed assets	(21,196)	0

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Restructuring costs (especially personnel costs and expenses arising from current contracts)	(21,575)	0
Costs of disposal/ liquidation	(17,398)	0
Sundry expenses	(1,747)	0
<b>Extraordinary income</b>	<b>76</b>	<b>0</b>
Proceeds from disposal	76	0
	<hr/>	<hr/>
<b>Total</b>	<b>(98,264)</b>	<b>0</b>
	<hr/>	<hr/>

All the effects on net profit of the closure of comdirect S.p.A. and the disposal of comdirect S.A. are included in this item.

(7) For the purposes of this filing, please refer to page A-140.

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(30) Taxes on income**

	<u>2001</u>	<u>2000</u>
	( thousand ) (unaudited)	
Current taxes on income	(906)	32,048
Deferred taxes	10,983	(8,677)
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>10,077</b>	<b>23,371</b>
	<b>—————</b>	<b>—————</b>

*Transitional presentation of income taxes*

	<u>2001</u>
	( thousand ) (unaudited)
<b>Profit from ordinary activities</b>	<b>(150,580)</b>
multiplied by the German income tax rate of 36.93%	
= calculated income-tax expenses in part financial year	(55,609)
- effects of different domestic tax rates on current income taxes and deferred taxes	623
- effects of different income-tax rates in the various countries where group companies based	2,109
+ amortisation of goodwill	10,311
+ effects of taxes on income in previous years	2,149
+ effects due to extraordinary results	75,392
+ effects on deferred taxes on losses carried forward	8,816
- effect of consolidation measures	27,586
- other causes	664
	<u>          </u>
<b>Total</b>	<b>10,077</b>
	<b>—————</b>

**(31) Cash reserve**

Cash reserve breaks down as follows:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand ) (unaudited)	
Cash on hand	232	131
Balances with central banks	71,773	384
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>72,005</b>	<b>515</b>
	<b>—————</b>	<b>—————</b>

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The minimum reserve requirement to be met at the end of December 2001 totalled 44,756 thousand (2000: 40,690 thousand).

**(32) Claims on banks**

	<b>Total</b>		<b>Due on demand</b>		<b>Other claims</b>	
	<b>31.12.2001</b>	<b>31.12.2000</b>	<b>31.12.2001</b>	<b>31.12.2000</b>	<b>31.12.2001</b>	<b>31.12.2000</b>
	( thousand) (unaudited)					
German banks	1,600,166	959,357	1,098,541	291,935	501,625	667,422
Foreign banks	83,946	47,120	46,446	47,120	37,500	0
<b>Total</b>	<b>1,684,112</b>	<b>1,006,477</b>	<b>1,144,987</b>	<b>339,055</b>	<b>539,125</b>	<b>667,422</b>

Claims on banks include foreign-currency amounts equal to 39,310 thousand (2000: 15,535).

Claims on banks primarily consist of overnight money and fixed deposits ( 1,634,874 thousand/2000: 964,015 thousand, incl. occurred interest ).

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(33) Claims on customers**

Claims on customers consist of:

	Total		Due on demand		Other claims	
	31.12.2001	31.12.2000	31.12.2001	31.12.2000	31.12.2001	31.12.2000
	( thousand) (unaudited)					
<b>Claims on domestic customers</b>	<b>261,293</b>	<b>571,294</b>	<b>261,293</b>	<b>561,265</b>	<b>0</b>	<b>10,029</b>
Public-sector entities	0	10,029	0	0	0	10,029
Private customers	261,293	561,265	261,293	561,265	0	0
<b>Claims on foreign customers</b>	<b>2,435</b>	<b>4,230</b>	<b>2,435</b>	<b>4,230</b>	<b>0</b>	<b>0</b>
Private customers	2,435	4,230	2,435	4,230	0	0
<b>Total</b>	<b>263,728</b>	<b>575,524</b>	<b>263,728</b>	<b>565,495</b>	<b>0</b>	<b>10,029</b>

All claims on private customers are deemed to be due on demand. Claims on customers include 250,603 thousand (2000: 548,127 thousand) from loans to finance purchases of securities. These claims are loans secured by securities. In view of the concentration of loans, we point out that the original loan business is carried out with private customers only. Claims on customers include foreign-currency amounts equal to 75 thousand (2000: 15 thousand).

**(34) Provision for possible loan losses**

	Credit default risks		General provisions		Total	
	31.12.2001	31.12.2000	31.12.2001	31.12.2000	31.12.2001	31.12.2000
	( thousand) (unaudited)					
Balance 1 January	(3,149)	(1,254)	(31)	(31)	(3,180)	(1,285)
Allocations	(4,215)	(2,151)	0	0	(4,215)	(2,151)
Deductions	2,459	256	0	0	2,459	256
of which utilised	103	45	0	0	103	45
of which written back	2,356	211	0	0	2,356	211
Exchange-rate changes	0	0	0	0	0	0
<b>Provision for possible loan losses as of 31 December</b>	<b>(4,905)</b>	<b>(3,149)</b>	<b>(31)</b>	<b>(31)</b>	<b>(4,936)</b>	<b>(3,180)</b>

The adjusted value of non-interest bearing non-productive claims amounts to 4,943 thousand (2000: 3,268 thousand).

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The comdirect Group made a direct write-down of 222 thousand (2000: 37 thousand) and recorded receipts on written-down claims in an amount of 7 thousand (2000: 11 thousand).

The total balance of risk provisions for credit default risks breaks down as:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
German borrowers	(4,831)	(3,137)
Foreign borrowers	(74)	(12)
<b>Total</b>	<b><u>(4,905)</u></b>	<b><u>(3,149)</u></b>

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(35) Trading assets**

Under this item, financial instruments acquired as part of the small trading portfolio are shown at fair value. In addition, derivative financial instruments assigned to trading with positive fair values and interest for the respective period appear here.

	31.12.2001	31.12.2000
	( thousand ) (unaudited)	
<b>Shares and other non-fixed interest</b>	<b>1,226</b>	<b>883</b>
Shares	0	883
German securities	0	636
Foreign securities	0	247
Other non-fixed interest securities	1,226	0
<b>Positive market value attributable to derivative financial instruments</b>	<b>938</b>	<b>0</b>
Interest-rate derivatives	938	0
	<b>2,164</b>	<b>883</b>
<b>Total</b>	<b>2,164</b>	<b>883</b>

There were no restrictions on the disposal of any of the trading assets as of the balance sheet date.

**(36) Financial investments**

All the financial instruments shown under Financial investments are assigned to the available for sale category and are measured at fair value.

	31.12.2001	31.12.2000
	( thousand ) (unaudited)	
Bonds and other fixed-income securities of the available for sale portfolio	840,719	910,943
Bonds and notes	840,719	910,943
issued public-sector borrowers	0	0
issued by other borrowers	840,719	910,943
Investments	0	10,500
Shares and other non-fixed interest securities of the available for sale portfolio	20,493	231,796
Holdings in subsidiaries	0	0
	<b>861,212</b>	<b>1,153,239</b>
<b>Total</b>	<b>861,212</b>	<b>1,153,239</b>

There were no restrictions on the disposal of any of the financial assets as of the balance-sheet date.

Through a resolution of 31 December, 2001 the Wiesbaden lower regional court opened bankruptcy proceedings against the assets of Censio AG. We no longer expect a repayment of capital. For this reason,

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comdirect bank AG entirely wrote its investment in 2001. The impact of this write-off on the bank's net profit and loss is shown under the position Extraordinary result and restructuring costs.

On the balance-sheet date, no write-downs were made due to permanent impairment on financial instruments measured at fair value.

### (37) Intangible assets

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Goodwill	0	27,052
Other intangible assets	22,076	13,898
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>22,076</b>	<b>40,950</b>
	<b>_____</b>	<b>_____</b>

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

Changes in fixed assets are shown in schedule of assets (page 70<sup>(8)</sup>, note 39).

**(38) Fixed assets**

	31.12.2001	31.12.2000
	( thousand) (unaudited)	
<b>Office and furniture equipment</b>	<b>45,816</b>	<b>76,335</b>

Changes in fixed assets are shown in schedule of assets (page 70<sup>(8)</sup>, note 39).

**(39) Schedule of assets**

	Fixed assets		Intangible assets		
	Software	Other	Other	Goodwill	Investments
	( thousand) (unaudited)				
<b>Book value as of 1 January 2001</b>	<b>10,705</b>	<b>65,630</b>	<b>13,898</b>	<b>27,052</b>	<b>10,500</b>
Costs of acquisition/ manufacture as of					
1 January 2001	17,919	89,213	20,841	28,813	10,500
Additions 2001	5,344	10,041	12,898	915	0
Disposals 2001	(2,065)	(910)	0	0	0
Costs of acquisition/ manufacture as of					
31 December 2001	21,198	98,344	33,739	29,728	10,500
Cumulative write-downs as of					
1 January 2001	7,214	23,583	6,943	1,761	0
Additions 2001	9,173	36,067	4,720	27,967	10,500
Disposals 2001	(826)	(1,485)	0	0	0
Cumulative write-downs as of					
31 December 2001	15,561	58,165	11,663	29,728	10,500
<b>Book value as of 31 December 2001</b>	<b>5,637</b>	<b>40,179</b>	<b>22,076</b>	<b>0</b>	<b>0</b>

Additions to write-downs in 2001 relate to extraordinary write-downs of 57.620 thousand. These are spread between the items goodwill, investments, fixed assets and intangible assets.

**(40) Other assets**

	31.12.2001	31.12.2000
	( thousand) (unaudited)	
Deferred items	5,693	1,211
Sundry assets	12,507	14,472
<b>Total</b>	<b>18,200</b>	<b>15,683</b>

Sundry assets comprise the following items:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Claims on affiliated companies	8,494	9,446
Other	4,013	5,026
	<u>          </u>	<u>          </u>
<b>Total</b>	<b><u>12,507</u></b>	<b><u>14,472</u></b>

(8) For the purposes of this filing, please refer to page A-148.  
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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(41) Liabilities to banks**

	Total		Due on demand		Other liabilities	
	31.12.2001	31.12.2000	31.12.2001	31.12.2000	31.12.2001	31.12.2000
	( thousand) (unaudited)					
German banks	0	1,918	0	0	0	1,918
Foreign banks	0	1,760	0	0	0	1,760
<b>Total</b>	<b>0</b>	<b>3,678</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>3,678</b>

**(42) Liabilities to customers**

	Total		Due on demand		Other liabilities	
	31.12.2001	31.12.2000	31.12.2001	31.12.2000	31.12.2001	31.12.2000
	( thousand) (unaudited)					
Liabilities to domestic private customers	2,196,023	2,011,316	2,150,113	1,999,863	45,910	11,453
Liabilities to foreign private customers	93,304	33,238	92,433	32,979	871	259
<b>Total</b>	<b>2,289,327</b>	<b>2,044,554</b>	<b>2,242,546</b>	<b>2,032,842</b>	<b>46,781</b>	<b>11,712</b>

Foreign-currency amounts equal to 28,846 thousand (2000: 2,550 thousand).

Through the deposit insurance scheme of the Association of German Banks, Cologne, each customer of comdirect bank AG is insured for deposits of up to 233 millions.

In addition, comdirect bank AG is a member of Entschädigungseinrichtung deutscher Banken GmbH.

**(43) Provisions**

	31.12.2001	31.12.2000
	( thousand) (unaudited)	
Provisions for pensions and similar commitments	1,775	1,337
Other provisions	49,576	4,391
<b>Total</b>	<b>51,351</b>	<b>5,728</b>

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The changes in provisions for pensions were as follows:

	<u>as of</u> <u>1.1.2001</u>	<u>Utilised/</u> <u>change</u>	<u>Depreciation</u>	<u>Allocation</u>	<u>as of</u> <u>31.12.2001</u>
			( thousand) (unaudited)		
Pension expectancies of active employees	1,337	0	0	438	1,775

The allocations to pension provisions in 2001 break down as follows:

Service cost	312 (thousand)
Interest cost	95 (thousand)
Cost arising from changes in actuarial assumptions	2 (thousand)

In the 2001 financial year, comdirect bank AG took over pension provisions of 29 thousand due to staff recruitment.

Actuarial gains and losses are amortised over three years (2001:2 thousand).

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

Parameters	31.12.2001	31.12.2000	31.12.1999
	(unaudited)	(unaudited)	(unaudited)
Calculatory interest rate	5.75%	6.50%	5.75%
Changes in salaries	3.00%	3.50%	3.00%
Changes in pensions	1.50%	2.00%	2.00%

Changes in other provisions:

	as of 1.1.2001	Utilised	Depreciation	Allocation	as of 31.12.2001
	( thousand ) (unaudited)				
Provisions for staff	2,277	1,757	324	2,033	2,229
Provisions for anniversary bonuses	87	33	45	32	41
Provisions for non-income-related taxes	145	0	0	877	1,022
Provisions for contingent losses	0	0	0	44,234	44,234
Other provisions	1,882	851	815	1,834	2,050
<b>Total</b>	<b>4,391</b>	<b>2,641</b>	<b>1,184</b>	<b>49,010</b>	<b>49,576</b>

Provisions for staff mainly relate to provisions for bonuses. The provisions for staff will probably be used in the 2002 financial year.

Changes in provisions for contingent losses break down as follows:

	as of 1.1.2001	Utilised	Depreciation	Allocation	as of 31.12.2001
	( thousand ) (unaudited)				
<b>Provisions for contingent losses</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>44,234</b>	<b>44,234</b>
Restructuring	0	0	0	39,890	39,890
Other	0	0	0	4,344	4,344

The scale of the contingent losses for restructuring was measured on the basis of the information expected expenses that were available when the financial statements were prepared.

**(44) Tax liabilities**

Tax liabilities are comprised as follows:

	31.12.2001	31.12.2000
	( thousand ) (unaudited)	
<b>Current tax liabilities</b>	<b>5,683</b>	<b>7,287</b>

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Provisions for income taxes	5,683	7,287
<b>Deferred tax liabilities</b>	<b>4,761</b>	<b>3,507</b>
	<hr/>	<hr/>
<b>Total</b>	<b>10,444</b>	<b>10,794</b>
	<hr/>	<hr/>

The provision for taxes on income includes tax liabilities for which no final formal assessment note has been received. Deferred taxes are attributable to temporary differences between the values assigned to assets and liabilities in the balance sheet according to IAS and the balance sheets prepared by Group companies in accordance with local tax provisions.

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

Deferred tax liabilities were created in connection with the following balance sheets accounts:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Provision for possible loan losses	23	23
Trading assets	347	0
Financial investments	2,300	(1,559)
Intangible assets	7,575	5,237
Fixed assets	(68)	0
Provisions	(2,226)	(194)
Equity	(3,190)	0
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>4,761</b>	<b>3,507</b>

The domestic income tax rate used to compute deferred taxes is composed of the applicable tax rates effective in Germany for corporate income tax (25.0%), plus the solidarity surcharge (5.5%) and the trade tax (14.3%) taken together. This yields a domestic income tax rate of 36.93%.

**(45) Subordinated capital**

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Subordinated liabilities	6,391	6,391
Profit-sharing certificates outstanding	10,226	23,008
	<u>          </u>	<u>          </u>
<b>Total</b>	<b>16,617</b>	<b>29,399</b>

The subordinated capital ( 16,617 thousand) meets the requirements of supplementary capital as defined by Art. 10, paragraph 5(a) of the German Banking Act. The claims of creditors to repayment of these liabilities are subordinate to those of other creditors.

Terms of subordinated liabilities:

<u>Start of maturity (unaudited)</u>	<u>Amount thousand</u>	<u>Interest rate per 31.12.2001</u>	<u>Maturity date</u>
1996	6,391	3.549%	2006

The interest rate on subordinated liabilities is fixed for three years from the beginning of the period, after which the interest rate is adjusted annually.

During the financial year, comdirect incurred interest expenses on subordinated liabilities of 317 thousand (2000: 270 thousand).

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Interest is paid only insofar as such payments do not lead to an accounting loss. The claims of the holders of the profit-sharing certificates are subordinated to the claims of other creditors.

Terms of the profit-sharing certificates:

<b>Start of maturity (unaudited)</b>	<b>Amount thousand</b>	<b>Interest rate per 31.12.2001</b>	<b>Maturity date</b>
1998	10,226	6.000%	2006

During the financial year comdirect incurred interest expenses on profit-sharing certificates of 733 thousand (2000: 1,221 thousand). This includes also interest expenses for profit-sharing certificates of 12,782 thousand, which was repaid in 2001. As a net loss for the year is shown, the interest payment for the current profit-sharing right will not be made in the 2002 financial year.

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(46) Maturities, by remaining lifetime**

**Remaining lifetimes as of 31.12.2001**

	<b>Total</b>	<b>Due on demand and unlimited in time</b>	<b>Up to three months</b>	<b>Three months to one year</b>	<b>One to five years</b>	<b>More than five years</b>
	( thousand) (unaudited)					
Claims on banks	1,684,112	1,144,987	339,125	50,000	150,000	0
Claims on customers	263,728	263,728	0	0	0	0
Bonds and notes held in the available for sale portfolio	840,719	20,873	51,362	163,860	501,083	103,541
<b>Total</b>	<b>2,788,559</b>	<b>1,429,588</b>	<b>390,487</b>	<b>213,860</b>	<b>651,083</b>	<b>103,541</b>
Liabilities to banks	0	0	0	0	0	0
Liabilities to customers	2,289,327	2,242,546	20,052	24,844	1,885	0
Subordinated capital	16,617	0	0	0	16,617	0
<b>Total</b>	<b>2,305,944</b>	<b>2,242,546</b>	<b>20,052</b>	<b>24,844</b>	<b>18,502</b>	<b>0</b>

**Remaining lifetimes as of 31.12.2000**

	<b>Total</b>	<b>Due on demand and unlimited in time</b>	<b>Up to three months</b>	<b>Three months to one year</b>	<b>One to five years</b>	<b>More than five years</b>
	( thousand) (unaudited)					
Claims on banks	1,006,477	339,049	414,620	102,559	150,249	0
Claims on customers	575,524	565,495	10,029	0	0	0
Bonds and notes held as financial investments	910,943	0	99,423	269,574	459,608	82,338
<b>Total</b>	<b>2,492,944</b>	<b>904,544</b>	<b>524,072</b>	<b>372,133</b>	<b>609,857</b>	<b>82,338</b>
Liabilities to banks	3,678	3,678	0	0	0	0
Liabilities to customers	2,044,554	2,032,842	5,019	4,729	1,964	0
Subordinated capital	29,399	12,782	0	0	0	16,617
<b>Total</b>	<b>2,077,631</b>	<b>2,049,302</b>	<b>5,019</b>	<b>4,729</b>	<b>1,964</b>	<b>16,617</b>

**(47) Claims on/liabilities to affiliated companies**

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Claims on banks	754,471	501,358
Liabilities to banks	0	3,678
Subordinated capital	16,617	29,399
<b>Total</b>	<b><u>771,088</u></b>	<b><u>534,435</u></b>

**(48) Interest-rate risks**

	<u>Fixed-interest assets</u>		<u>Fixed-interest liabilities</u>		<u>Fixed- interest gap</u>	<u>Interest differential</u>
	<u>million</u>	<u>interest in %</u>	<u>million</u>	<u>interest in %</u>	<u>million</u>	<u>% points</u>
	(unaudited)		(unaudited)		(unaudited)	
Up to one year	2,704	4.00	2,524	1.88	(180)	2.12
One to five years	258	4.42	765	4.08	507	(0.34)
More than five years	20	5.25	17	5.60	(3)	(0.35)

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(49) Number of employees at the end of the reporting period**

	31.12.2001	31.12.2000
	(unaudited)	
Group	1,291	1,536
in Germany	1,117	1,387
abroad	174	149
<b>At comdirect bank AG</b>	<b>1,117</b>	<b>1,387</b>
of which:		
in the call centre	517	854
in the back office	317	303
in other areas	283	230

**(50) Segment reporting**

Segment reporting by geographical markets:

	comdirect Germany	comdirect Europe, excluding Germany	Group management/ others/ consolidation	comdirect bank group total
	( thousand) (unaudited)			
Net interest income before provisions	72,610	1,473	0	74,083
Provision for possible loan losses	(2,074)	0	0	(2,074)
Net interest income after provisions	70,536	1,473	0	72,009
Net commission income	91,719	1,299	0	93,018
Trading profit	(29)	0	0	(29)
Result from the securities portfolio (available for sale)	344	0	0	344
Administrative expenses	159,767	64,550	0	224,317
Other operating result	9,241	(786)	(1,796)	6,659
<b>Profit from ordinary activities</b>	<b>12,044</b>	<b>(62,564)</b>	<b>(1,796)</b>	<b>(52,316)</b>
Extraordinary result and restructurings costs	(215,311)	(28,204)	145,251	(98,264)
<b>Pre-tax profit</b>	<b>(203,267)</b>	<b>(90,768)</b>	<b>143,455</b>	<b>(150,580)</b>
Taxes on income	1,261	8,816	0	10,077
<b>After-tax profit</b>	<b>(204,528)</b>	<b>(99,584)</b>	<b>143,455</b>	<b>(160,657)</b>
Profit/loss attributable to minority interests	0	0	0	0
<b>Net income/Net loss</b>	<b>(204,528)</b>	<b>(99,584)</b>	<b>143,455</b>	<b>(160,657)</b>
<b>Acquisition costs of segment assets</b>	<b>16,425</b>	<b>12,773</b>		<b>29,198</b>
<b>Depreciation of segment assets</b>	<b>20,248</b>	<b>8,458</b>		<b>28,706</b>
<b>Cost/Income ratio</b>	<b>0.9206</b>	<b>32.5025</b>		<b>1.2912</b>
<b>Segment earnings</b>	<b>241,633</b>	<b>6,474</b>	<b>247</b>	<b>248,354</b>
<b>Segment expenses</b>	<b>229,933</b>	<b>69,038</b>	<b>2,043</b>	<b>301,014</b>
<b>Segment assets</b>	<b>1,932,769</b>	<b>92,304</b>	<b>(8,000)</b>	<b>2,017,073</b>
<b>Segment debts</b>	<b>2,252,532</b>	<b>44,795</b>	<b>(8,000)</b>	<b>2,289,327</b>

Allocation to the segments is based on the domicile of the subsidiaries or the consolidated company.

**(51) Other liabilities**

Rental and leasing agreements concluded by comdirect will lead to expenses of 7,074 thousand during the 2002 financial year, 9,216 thousand for each of the years 2003 to 2006, and 6,170 thousand as of the year 2007.

A job guarantee has been given to the city of Kiel.

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**COMDIRECT BANK GROUP  
NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(52) Letter of comfort**

comdirect bank AG provides no general letter of comfort for the subsidiaries included in the consolidated financial statements.

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**COMDIRECT BANK GROUP  
NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(53) The company's boards**

***Supervisory board***

**Klaus-Peter Müller**

(since of 10 May, 2001)  
Frankfurt am Main  
Chairman of the Supervisory Board  
Chairman of the Board of Managing Directors of Commerzbank AG,  
Frankfurt am Main

**Dr. Norbert Käsbeck**

(until 10 May, 2001 Chairman of the Supervisory Board)  
Frankfurt am Main  
Member of the Board of Managing Directors of Commerzbank AG,  
Frankfurt am Main

**Klaus Müller-Gebel**

Frankfurt am Main  
Deputy Chairman of the Supervisory Board  
Member of the Board of Managing Directors of Commerzbank AG,  
Frankfurt am Main

**Dr. Franz-Georg Brune**

(since 10 May, 2001)  
Frankfurt am Main  
Co-manager of Frankfurt am Main main branch of Commerzbank AG,  
Frankfurt am Main

**Dr. Ferdinand Vogel**

(until 10 May, 2001)  
Frankfurt am Main  
Head of IT Development service department  
Director of Commerzbank AG,  
Frankfurt am Main

**Burkhard Graßmann**

Weiterstadt  
Member of the Board of Managing Directors of  
T-Online International AG, Weiterstadt

**Angelika Kierstein**

Quickborn  
Chairman of Staff Council of comdirect bank Aktiengesellschaft  
Commercial employee

**Maria Xiromeriti**

Quickborn  
Deputy Chairman of Staff Council of comdirect bank  
Aktiengesellschaft  
Commercial employee

*Vorstand*

**Bernt Weber**

**Christian Jessen**  
**Hans-Joachim Nitschke**  
**Dr. Andre Carls**

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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(54) Shares of comdirect bank AG**

Number of shares held by the boards:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	(unaudited)	
<b>Members of the Board of Managing Directors</b>	<b>700</b>	<b>700</b>
Dr. Andre Carls	0	0
Christian Jessen	200	200
Hans-Joachim Nitschke	0	0
Bernt Weber	500	500
<b>Members of the Supervisory Board</b>	<b>150</b>	<b>250</b>
Klaus-Peter Müller	0	0
Klaus Müller-Gebel	0	0
Dr. Franz-Georg Brune	0	0
Burkhard Graßmann	0	0
Angelika Kierstein	100	200
Maria Xiromeriti	50	50

The number of options held to subscribe to comdirect bank AG shares breaks down as follows:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	(unaudited)	
<b>Members of the Board of Managing Directors</b>	<b>90,000</b>	<b>36,000</b>
Dr. Andre Carls	13,500	0
Christian Jessen	25,500	12,000
Hans-Joachim Nitschke	25,500	12,000
Bernt Weber	25,500	12,000
<b>Members of the Supervisory Board</b>	<b>0</b>	<b>0</b>
Klaus-Peter Müller	0	0
Klaus Müller-Gebel	0	0
Dr. Franz-Georg Brune	0	0
Burkhard Graßmann	0	0
Angelika Kierstein	0	0
Maria Xiromeriti	0	0



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**COMDIRECT BANK GROUP**  
**NOTES FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2001 (UNAUDITED) (Continued)**

**(55) Remuneration and loans to board members**

The following remuneration was paid to members of the Board of Managing Directors and members of the Supervisory Board:

	<u>31.12.2001</u>	<u>31.12.2000</u>
	( thousand) (unaudited)	
Board of Managing Directors	1,290	783
Supervisory Boards	87	99

Neither advance payments nor loans were extended.comdirect did not take on any contingent liabilities.

**Holdings**

Affiliated companies included in the consolidation:

<u>Name</u>	<u>Domicile</u>	<u>Share of capital held in %</u>	<u>Equity in thousand</u>		
comdirect ltd	London/ United Kingdom	100.0	GBP	10,485	
comdirect nominee ltd	London/ United Kingdom	100.0	GBP	(1,00)	
comdirect S.A.	Paris/ France	99.3	EUR	13,064	
comdirect bank S.p.A	Milan/ Italy	100.0	EUR	6,374	

Quickborn, 25 February 2002

The Board of Managing Directors

Bernt Weber	Christian Jessen	Hans-Joachim Nitschke	Dr. Andre Carls
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